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Internal Revenue Bulletin

Cumulative Bulletin 1956–1

JANUARY–JUNE 1956

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INTERNAL REVENUE BULLETIN

3681

CUMULATIVE BULLETIN 1956-1

January–June 1956

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ABBREVIATIONS

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

A, B, C, etc.—The names of individuals.
A. T.—Alcohol and tobacco tax ruling.
B. T. A.—Board of Tax Appeals.
C. B.—Cumulative Bulletin.
C. F. R.—Code of Federal Regulations.
Ct. D.—Court Decision.
D. C.—Treasury Department circular.
E. O.—Executive Order.
E. T.—Estate and gift tax ruling.
Em. T.—Employment tax ruling.
F. A. A. A.—Federal Alcohol Administration Act.
F. R.—Federal Register.
G. C. M.—Chief Counsel's memorandum (formerly General Counsel's memorandum).
I. R. B.—Internal Revenue Bulletin.
IR-Mim.—Published IR-Mimeograph.
I. T.—Income Tax ruling.
M, N, X, Y, Z, etc.—The names of corporations, places or businesses according to context.
M. T.—Miscellaneous tax ruling.
Mim.—Published mimeograph.
O. D.—Office Decision.
P. L.—Public Law.
P. S.—Pension, profit-sharing, stock bonus, or annuity plan ruling.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
Sol. Op.—Solicitor's Opinion.
S. P. R.—Statement of Procedural Rules.
S. T.—Sales tax ruling.
Stat.—Statutes at Large.
T. C.—The Tax Court of the United States.
T. D.—Treasury Decision.
U. S. C.—United States Code.
x and *y* used to represent certain numbers and when used with the word "dollars" represent sums of money.

INTRODUCTION

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for the announcement of official Internal Revenue rulings, and for the publication of Treasury Decisions, Executive Orders, legislation, and court decisions pertaining to Internal Revenue matters.

It is the policy of the Service to publish in the Bulletin all substantive and procedural rulings of importance or general interest, the publication of which is considered necessary to promote a uniform application of the laws administered by the Service. It is also the policy to publish all rulings which revoke, modify, amend, or affect any published ruling. Rulings relating solely to matters of internal management are not published. The rulings are prepared in the various divisions of the National Office, including the Office of the Chief Counsel for the Internal Revenue Service. All published rulings have received the consideration and approval of the Chief Counsel.

Revenue Rulings and Revenue Procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations (including Treasury Decisions), but are published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for this purpose. However, since each published ruling represents the conclusion of the Service as to the application of the law to the entire state of facts involved, Revenue officers and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same. In applying rulings published in the Bulletin, personnel of the Service will, of course, consider the effect of subsequent legislation, regulations, court decisions, and rulings.

Each ruling is designated as a "Revenue Ruling" and each published procedure is designated as a Revenue Procedure. These should be cited by reference to the Bulletin and page where reported. Thus, Revenue Ruling No. 56–250 should be cited as "Rev. Rul. 56–250, C. B. 1956–1, 659." Similarly, Revenue Procedure No. 56–1 should be cited as Rev. Proc. 56–1, C. B. 1956–1, 1016. Rulings are keyed to the applicable sections of the Internal Revenue Code and regulations.

Internal Revenue Cumulative Bulletin 1956–1 contains all rulings, decisions, and legislation pertaining to Internal Revenue matters published in the weekly Internal Revenue Bulletins 1 to 26, inclusive, for the period January 1 to June 30, 1956. It also contains a cumulative list of announcements relating to decisions of The Tax Court of the United States, published in the Internal Revenue Bulletins.

FOREWORD

The Cumulative Bulletin is prepared in five parts, as follows:

I. Part I includes rulings and decisions which are based on the application of provisions of the Internal Revenue Code of 1954 and, unless otherwise stated in the ruling or decision, are published without consideration as to any application of the provisions of the Internal Revenue Code of 1939 or other related public laws.

II. Part II includes rulings and decisions which are based on the application of the Internal Revenue Code of 1939, the Federal Firearms Act, and other public laws except those pertaining to the various alcohol taxes; and, unless otherwise noted therein, they are published without consideration as to any application of the provisions of the Internal Revenue Code of 1954. Part II is subdivided into three subparts according to matters issued under the Internal Revenue Code of 1939 (Subpart A), the Federal Firearms Act (Subpart B), and other public laws (Subpart C).

III. Part III contains rulings and decisions pertaining to the various alcohol taxes. This part is subdivided into four subparts according to matters issued under the Internal Revenue Code of 1954 (Subpart A), the Internal Revenue Code of 1939 (Subpart B), the Federal Alcohol Administration Act (Subpart C), and other public laws (Subpart D).

IV. Part IV contains treaties and tax legislation, including related Committee and Conference Reports. This part is subdivided into three subparts according to tax conventions, Treasury Decisions and Revenue Rulings issued with respect thereto (Subpart A), legislation (Subpart B), and Committee Reports (Subpart C), House, Senate and Conference Committee Reports printed in the Bulletin do not include the portion entitled "Changes in Existing Law."

V. Part V is devoted to administrative, procedural, and miscellaneous matters. The weekly Internal Revenue Bulletins contained Part VI, consisting of some items of general interest. Other than the disbarment list and an interpretation of Treasury Circular No. 230, which have been incorporated in Part V of this Bulletin, those items are not reproduced herein.

THE TAX COURT OF THE UNITED STATES

CUMULATIVE LIST OF ANNOUNCEMENTS RELATING TO DECISIONS OF THE TAX COURT OF THE UNITED STATES PUBLISHED IN THE INTERNAL REVENUE BULLETIN FROM JANUARY 1, 1956, TO JUNE 30, 1956, INCLUSIVE

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[a] United States Board of Tax Appeals.

[1] See Rev. Rul. 56-282, page 701, this Bulletin.
[2] Nonacquiescence published in Cumulative Bulletin 1943, 26, relating only to the issue of the authority of section 3801(b)(5) of the 1939 Code for the adjustments proposed for 1934, 1936 and 1937, is withdrawn.
[3] Acquiescence relates to the issue whether the $20,000 award approved by the District Court in 1945 satisfied the 80 percent of total compensation requirement of section 107(a) of the 1939 Code. Acquiescence relating to the other issue in this case was published in Cumulative Bulletin 1955-2, 3.
[4] Nonacquiescences published in Cumulative Bulletin 1953-1, 7, are withdrawn.
[5] Estate tax decision.
[6] Nonacquiescence published in Cumulative Bulletin 1954-2, 6, is withdrawn. See Rev. Rul. 56-252, page 210, this Bulletin.
[7] See Rev. Rul. 56-145, page 612, this Bulletin.
[8] Nonacquiescence published in Cumulative Bulletin XIII-2, 29 (1934), is withdrawn.
[9] See Rev. Rul. 56-220, page 191, this Bulletin.
[10] See Rev. Rul. 56-191, page 636, this Bulletin.
[11] Nonacquiescences published in Cumulative Bulletin XII-1, 20 (1933), are withdrawn.
[12] Nonacquiescence published in Cumulative Bulletin XIII-2, 38 (1934), is withdrawn.
[13] Nonacquiescence published in Cumulative Bulletin XI-2, 18 (1932), is withdrawn.

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PART I

RULINGS AND DECISIONS UNDER THE INTERNAL REVENUE CODE OF 1954

Rulings and decisions published in Part I of the Internal Revenue Bulletin are based on the application of provisions of the Internal Revenue Code of 1954 and, unless otherwise stated in the rulings or decisions, are published without consideration as to any application of the provisions of the Internal Revenue Code of 1939 or related public laws.

SUBTITLE A.—INCOME TAXES

CHAPTER 1.—NORMAL TAXES AND SURTAXES

SUBCHAPTER A.—DETERMINATION OF TAX LIABILITY

PART I.—TAX ON INDIVIDUALS

SECTION 1.—TAX IMPOSED

26 CFR 1.01: Internal Revenue Code of 1954 and regulations.
(Also Section 116; 1.116.)

T. D. 6161 [1]

TITLE 26—INTERNAL REVENUE, 1954—CHAPTER 1, SUBCHAPTER A, PART I.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Regulations prescribed under sections 1 to 38, and section 116, inclusive, of the Internal Revenue Code of 1954.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others CONCERNED:

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[1] 21 F. R. 788.

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AUTHORITY: §§ 1.01 to 1.38, incl., and 1.116 to 1.116–2, incl., issued under secs. 31 and 7805, I. R. C. 1954; 68A Stat. 12, 917; 26 U. S. C. 31, 7805.

On July 13, 1955, notice of proposed rulemaking regarding the regulations for taxable years beginning after December 31, 1953, and ending after August 16, 1954, except where otherwise provided, under sections 1 to 38, inclusive, and section 116 of the Internal Revenue Code of 1954, was published in the Federal Register (20 F. R. 4986). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the following regulations, which give effect to the amendment made by Public Law 299 (84th Congress), are hereby adopted:

§ 1.01 INTERNAL REVENUE CODE OF 1954 AND REGULATIONS—(a) *Enactment of law.*—The Internal Revenue Code of 1954 which became law upon enactment of Public Law 591, 83d Congress, approved August 16, 1954, provides in part as follows:

> *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:
>
> * * * * * * *

In general, the provisions of the Internal Revenue Code of 1954 are applicable with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954. Certain provisions of that Code are deemed to be included in the Internal Revenue Code of 1939. See section 7851.

(b) *Scope of regulations.*—The regulations in this part deal with (1) the income taxes imposed under subtitle A of the Internal Revenue Code of 1954, and (2) certain administrative provisions contained in subtitle F relating to such taxes. The applicability of such regulations is commensurate with the applicability of the respective provisions of the Internal Revenue Code of 1954 except that with respect to the provisions of the Internal Revenue Code of 1954 which are deemed to be included in the Internal Revenue Code of 1939, the regulations relating to such provisions are applicable to certain fiscal years and short taxable years which are subject to the Internal Revenue Code of 1939. Those provisions of the regulations which are applicable to taxable years subject to the Internal Revenue Code of 1939 and the specific taxable years to which such provisions are so applicable are identified in each instance. The regulations in part 39, 26 CFR (1939), Regulations 118, insofar as taxable years beginning after December 31, 1953, and ending after August 16, 1954, are concerned, are superseded by the regulations in this part.

INCOME TAXES

NORMAL TAXES AND SURTAXES

DETERMINATION OF TAX LIABILITY

TAX ON INDIVIDUALS

§ 1.1 STATUTORY PROVISIONS; TAX IMPOSED; RATES OF TAX ON INDIVIDUALS.

SEC. 1. TAX IMPOSED.

(a) *Rates of tax on individuals.*—A tax is hereby imposed on 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 $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.

§ 1.1-1 INCOME TAX ON INDIVIDUALS.—(a) *General rule.*—(1) Section 1(a) of the Internal Revenue Code of 1954 imposes an income tax on every individual, resident or nonresident, other than a head of a household to whom subsection (b) applies or a nonresident alien individual subject to the tax imposed by section 871(a). This tax consists of a normal tax and a surtax. See section 1(c). For optional tax in the case of taxpayers with adjusted gross income of less than $5,000, see section 3. The tax imposed by section 1(a) is upon taxable income (determined by subtracting the allowable deductions from the gross income). The tax is determined in accordance with the table contained in section 1(a). In certain cases credits are allowed against the amount of the tax. See part IV of subchapter A of

chapter 1 of the Internal Revenue Code of 1954 (section 31 and following sections). In general, the tax is payable upon the basis of returns rendered by persons liable therefor (subchapter A of chapter 61 of the Internal Revenue Code of 1954 (sections 6001–6091, inclusive)) or at the source of the income. For computation of tax in the case of a joint return of husband and wife, or a return of a surviving spouse, see section 2. For other rates of tax on individuals, see section 5(a). See part III of subchapter G of chapter 1 of the Internal Revenue Code of 1954 (sections 551–557, inclusive) as to shareholders of foreign personal holding companies. See subchapter P of chapter 1 of the Internal Revenue Code of 1954 (sections 1201–1241, inclusive) as to the treatment of capital gains and losses.

(2) The income tax imposed by section 1(a) upon any amount of taxable income is computed by adding to the income tax for the bracket in which that amount falls in the table in section 1(a) the income tax upon the excess of that amount over the bottom of the bracket at the rate indicated in the table. Accordingly, the income tax for a taxable year beginning after December 31, 1953, upon a taxable income of $16,480 would be $5,440, computed as follows:

Tax on $16,000 (from table)	$5,200
Tax on $480 (at 50 percent as determined by the table)	240
Total tax on $16,480	5,440

(b) *Citizens or residents of the United States liable to tax.* In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Internal Revenue Code of 1954 whether the income is received from sources within or without the United States. A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is, in general, subject to taxation in the same manner as a resident alien individual. See section 876, relating to alien residents of Puerto Rico. As to tax on nonresident alien individuals, see section 871.

(c) *Who is a citizen.*—Every person born or naturalized in the United States and subject to its jurisdiction is a citizen. For rules governing loss of citizenship, see sections 349 to 357, inclusive, of the Immigration and Nationality Act, 1952 (8 U. S. C. 1481–1489). A foreigner who has filed his declaration of intention of becoming a citizen but who has not yet been admitted to citizenship by a final order of a naturalization court is an alien.

§ 1.1–2 Rates of Tax on Heads of Households.—(a) *General rule.*—An individual who is the head of a household under the rules prescribed in section 1(b) is subject to the income tax imposed by that section instead of the income tax imposed by section 1(a).

(b) *Definition of head of household.*—(1) For the purpose of section 1(b), the taxpayer shall be considered the head of a household if, and only if, he is not married at the close of his taxable year, is not a surviving spouse (as defined in section 2(b)), and (i) maintains as his home a household which constitutes for such taxable year the principal place of abode, as a member of such household, of at least one of the individuals described in section 1(b)(2)(A), or (ii) maintains (whether or not as his home) a household which constitutes for such taxable year the principal place of abode of one of the individuals described in section 1(b)(2)(B).

(2) Under no circumstances shall the same person be used to qualify more than one taxpayer as the head of a household for the same taxable year.

(3) Subparagraph (A) of section 1(b)(2) provides that any of the following persons may qualify the taxpayer as a head of a household:

(i) A son, stepson, daughter, or stepdaughter of the taxpayer, or a descendant of a son or daughter of the taxpayer. For the purpose of determining whether any of the stated relationships exist, a legally adopted child of a person is considered a child of such person by blood. If any such person is not married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person even though the taxpayer may not claim a deduction for such person under section 151, for example, because the taxpayer does not furnish more than half of the support of such person. However, if any such person is married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person only if the taxpayer is entitled to a deduction for such person under section 151 and the regulations thereunder. In applying the preceding sentence there shall be disregarded any such person for whom a deduction is allowed under section 151 only by reason of section 152(c) (relating to persons covered by a multiple support agreement).

(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 and the regulations thereunder. Under section 151 the taxpayer may be entitled to a deduction for any of the following persons:

(*a*) His brother, sister, stepbrother, or stepsister;
(*b*) His father or mother, or an ancestor of either;
(*c*) His stepfather or stepmother;
(*d*) A son or a daughter of his brother or sister;
(*e*) A brother or sister of his father or mother; or
(*f*) His son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law;

if such person has a gross income of less than $600 for the calendar year in which the taxable year of the taxpayer begins, if the taxpayer supplies more than one-half of the support of such person for such calendar year and if such person does not make a joint return with his spouse for the taxable year beginning in such calendar year. The taxpayer may not be considered to be a head of a household by reason of any person for whom a deduction is allowed under section 151 only by reason of section 152(a)(9), 152(a)(10), or 152(c) (relating to persons not related to the taxpayer, persons receiving institutional care, and persons covered by multiple support agreements).

(4) Subparagraph (B) of section 1(b)(2) provides that the father or mother of the taxpayer may qualify the taxpayer as a head of a household, but only if the taxpayer is entitled to a deduction for the taxable year for such father or mother under section 151 (determined without regard to section 152(c)). For example, an unmarried taxpayer who maintains a home for his widowed mother may not qualify as the head of a household by reason of his maintenance of a home for

his mother if his mother has gross income of $600 or more in the calendar year in which his taxable year begins, or if he does not furnish more than one-half of the support of his mother for such calendar year. For purposes of subparagraph (B) of section 1(b)(2), a person who legally adopted the taxpayer is considered the father or mother of the taxpayer.

(5) For the purpose of section 1(b), the status of the taxpayer shall be determined as of the close of the taxpayer's taxable year. A taxpayer shall be considered as not married if at the close of his taxable year he is legally separated from his spouse under a decree of divorce or separate maintenance, or if at any time during the taxable year the spouse to whom the taxpayer is married at the close of his taxable year was a nonresident alien. A taxpayer shall be considered married at the close of his taxable year if his spouse (other than a spouse who is a nonresident alien) dies during such year.

(6) If the taxpayer is a nonresident alien during any part of the taxable year he may not qualify as a head of a household even though he may comply with the other provisions of section 1(b). See the regulations prescribed under section 871 for a definition of nonresident alien.

(c) *Household.*—(1) In order for the taxpayer to be considered a head of a household by reason of any individual described in subparagraph (A) of section 1(b)(2), the household must actually constitute the home of the taxpayer for his taxable year. A physical change in the location of such home will not prevent a taxpayer from qualifying as a head of a household. Such home must also constitute the principal place of abode of at least one of the persons specified in such subparagraph (A). It is not sufficient that the taxpayer maintain the household without being its occupant. The taxpayer and such other person must occupy the household for the entire taxable year of the taxpayer. However, the fact that such other person is born or dies within the taxable year will not prevent the taxpayer from qualifying as a head of household if the household constitutes the principal place of abode of such other person for the remaining or preceding part of such taxable year. The taxpayer and such other person will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than six months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. Such absence will not prevent the taxpayer from qualifying as the head of a household if (i) it is reasonable to assume that the taxpayer or such other person will return to the household, and (ii) the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return.

(2) In order for the taxpayer to be considered a head of a household by reason of any individual described in subparagraph (B) of section 1(b)(2), the household must actually constitute the principal place of abode of the taxpayer's dependent father or mother, or both of them. It is not, however, necessary for the purposes of such subparagraph for the taxpayer also to reside in such place of abode. A physical change in the location of such home will not prevent a tax-

payer from qualifying as a head of a household. The father or mother of the taxpayer, however, must occupy the household for the entire taxable year of the taxpayer. They will be considered as occupying the household for such entire year notwithstanding temporary absences from the household due to special circumstances. For example, a nonpermanent failure to occupy the household by reason of illness or vacation shall be considered temporary absence due to special circumstances. Such absence will not prevent the taxpayer from qualifying as the head of a household if (i) it is reasonable to assume that such person will return to the household, and (ii) the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return. However, the fact that the father or mother of the taxpayer dies within the year will not prevent the taxpayer from qualifying as a head of a household if the household constitutes the principal place of abode of the father or mother for the preceding part of such taxable year.

(d) *Cost of maintaining a household.*—The taxpayer shall be considered as maintaining a household only if he pays more than one-half the cost thereof for his taxable year. The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants for such taxable year. The cost of maintaining a household shall not include expenses otherwise incurred. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, and transportation. In addition, the cost of maintaining a household shall not include any amount which represents the value of services rendered in the household by the taxpayer or by a person qualifying the taxpayer as a head of a household.

§ 1.1–3 Limitation on Tax.—The tax imposed by section 1 (whether by subsection (a) or by subsection (b) thereof) shall not exceed 87 percent of the taxable income for the taxable year. For purposes of determining this limitation the tax under section 1 (a) or (b) and the tax at the 87 percent rate shall each be computed before the allowance of any credits against the tax. Where the alternative tax on capital gains is imposed under section 1201(b), the 87 percent limitation shall apply only to the partial tax computed on the taxable income reduced by 50 percent of the excess of net long-term capital gain over net short-term capital loss.

§ 1.1–4 Determination of Normal Tax and Surtax.—The tax imposed by section 1 (whether by subsection (a) or by subsection (b) thereof) consists of a normal tax and a surtax. The normal tax equals 3 percent of the taxable income of the taxpayer and the surtax equals the remaining part of the combined tax computed in accordance with the tables in subsection (a) and subsection (b) of section 1 and with the limitation on tax in subsection (c) of section 1.

§ 1.1–5 Change in Rates Applicable to Taxable Year.—For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

§ 1.2 STATUTORY PROVISIONS; INCOME TAX IN CASE OF JOINT RETURN OR RETURN OF SURVIVING SPOUSE.

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.

§ 1.2–1 TAX IN CASE OF JOINT RETURN OF HUSBAND AND WIFE OR THE RETURN OF A SURVIVING SPOUSE.—(a) In the case of a joint return of husband and wife, or the return of a surviving spouse as defined in section 2 (b), the tax imposed by section 1 shall be twice the tax that would be imposed if the taxable income were reduced by one-half. For rules relating to the filing of joint returns of husband and wife and for method of computing gross income and adjusted gross income on such joint returns, see section 6013 and the regulations thereunder.

(b) The method of computing, under section 2 (a), the tax of husband and wife in the case of a joint return, or the tax of a surviving spouse, is as follows:

(1) First, the taxable income is reduced by one-half. Second, the tax is determined as provided by section 1 by using the taxable income so reduced. Third, the tax so determined, which is the tax that would be determined if the taxable income were reduced by one-half, is then multiplied by two to produce the tax imposed in the case of the joint return or the return of a surviving spouse, subject, however, to the allowance of any credits against the tax under the provisions of sections 31 through 38 and the regulations thereunder.

(2) The limitation under section 1(c) of the tax to an amount not in excess of a specified percent of the taxable income for the taxable year is to be applied before the third step above, that is, the limitation to be applied upon the tax is determined as the ap-

plicable specified percent of one-half of the taxable income for the taxable year (such one-half of the taxable income being the actual aggregate taxable income of the spouses, or the total taxable income of the surviving spouse, as the case may be, reduced by one-half). For the percent applicable in determining the limitation of the tax under section 1(c), see § 1.1–3. After such limitation is applied, then the tax so limited is multiplied by two as provided in section 2(a) (the third step above).

(3) The following computation illustrates the method of application of section 2(a) in the determination of the tax of a husband and wife filing a joint return for the calendar year 1954. If the combined gross income is $8,200, and the only deductions are the two exemptions of the taxpayers under section 151(b) and the standard deduction under section 141, the tax on the joint return for 1954, without regard to any credits against the tax, is $1,279.60, determined as follows:

1. Gross income		$8,200.00
2. Less: Standard deduction under section 141	$820	
Deduction for personal exemption	1,200	
		2,020.00
3. Taxable income		6,180.00
4. Taxable income reduced by one-half		3,090.00
5. Tax, computed by the tax table provided under section 1(a) ($400 plus 22 percent of excess of $3,090 over $2,000).		639.80
6. Twice the tax in item 5		1,279.60

(c) If the alternative tax is computed under section 1201(b), relating to the alternative tax where a taxpayer (other than a corporation) has a net long-term capital gain in excess of a net short-term capital loss, the partial tax shall be computed as provided in paragraph (b) of this section but without inclusion of 50 percent of such excess in taxable income, and the total tax shall be such partial tax plus a specified percent of such excess as provided in such section 1201(b).

(d) If a joint return of a husband and wife is filed under the provisions of section 6013 and if the husband and wife have different taxable years solely because of the death of either spouse, the taxable year of the deceased spouse covered by the joint return shall, for the purpose of the computation of the tax under section 2(a) in respect of such joint return, be deemed to have ended on the date of the closing of the surviving spouse's taxable year.

(e) For computation of optional tax in the case of a joint return or the return of a surviving spouse, see section 3 and the regulations thereunder.

(f) For treatment of taxable years during which a change in the tax rates occurs see section 21 and the regulations thereunder.

§ 1.2–2 Definition of Surviving Spouse.—(a) If a taxpayer is eligible to file a joint return (either under the Internal Revenue Code of 1939 without regard to section 51(b)(4) thereof or under the Internal Revenue Code of 1954 without regard to section 6013(a)(3) thereof) for the taxable year in which his spouse dies, his return for each of the next two taxable years following the year of the death of the spouse shall be treated as a joint return for purposes of sections 2(a) and 3 if all three of the following requirements are satisfied:

(1) He has not remarried before the close of the taxable year the return for which is sought to be treated as a joint return, and

(2) He 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 person who is (whether by blood or adoption) a son, stepson, daughter, or stepdaughter of the taxpayer, and

(3) He is entitled for the taxable year to a deduction under section 151 (relating to deductions for dependents) with respect to such son, stepson, daughter, or stepdaughter.

A return of a surviving spouse may not be treated as a joint return unless it is for a taxable year beginning after December 31, 1953, and ending after August 16, 1954.

(b) Section 1.1–2 (c) (1) and (d) (relating to the head of a household) provides rules for the determination under section 1 (b) (2) (A) of when the taxpayer maintains as his home a household which constitutes for the taxable year the principal place of abode, as a member of such household, of another person. These same rules shall also apply in the determination of whether the corresponding requirements under section 2 (b) (1) (B) have been satisfied.

(c) If the taxpayer does not qualify under section 2 as a surviving spouse he may nevertheless qualify under section 1 (b) as a head of a household if he meets the requirements of that section.

(d) The following example illustrates the provisions relating to a surviving spouse:

Example. Assume that the taxpayer meets the requirements of subparagraph (B) of section 2 (b) (1) for the years 1954 through 1958, and that the taxpayer, whose wife died during 1953 while married to him, remarried in 1955. In 1956, the taxpayer's second wife died while married to him, and he remained single thereafter. For 1954 the taxpayer will qualify as a surviving spouse, provided that neither the taxpayer nor the first wife was a nonresident alien at any time during 1953 and that she (immediately prior to her death) did not have a taxable year different from that of the taxpayer. For 1955 the taxpayer does not qualify as a surviving spouse because he remarried before the close of that taxable year. The taxpayer will qualify as a surviving spouse for 1957 and 1958, provided that neither the taxpayer nor the second wife was a nonresident alien at any time during 1956 and that she (immediately prior to her death) did not have a taxable year different from that of the taxpayer. On the other hand, if the taxpayer, in 1956, was divorced or legally separated from his second wife, the taxpayer will not qualify as a surviving spouse for 1957 or 1958, since he could not have filed a joint return for 1956 (the year in which his second wife died).

§ 1.3 Statutory Provisions; Optional Tax if Gross Income is Less Than $5,000.

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	264	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	164	146	26	0	0	0	0
1,150	1,175	80	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	783	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

§ 1.3–1 Application of Optional Tax.—(a) *General rules.*—(1) An individual whose adjusted gross income is less than $5,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $5,000) may elect to pay the tax imposed by section 3 in place of the tax imposed by section 1 (a) or (b). See § 1.4–2 for the manner of making such election. A taxpayer may make such election regardless of the sources from which his income is derived and regardless of whether his income is computed by the cash method or the accrual method. See section 62 and the regulations thereunder for the determination of adjusted gross income. For the purpose of determining whether a taxpayer may elect to pay the tax under section 3, the amount of the adjusted gross income is controlling, without reference to the number of exemptions to which the taxpayer may be entitled. See section 4 and the regulations thereunder for additional rules applicable to section 3.

(2) The following examples illustrate the rule that section 3 applies only if the adjusted gross income is less than $5,000:

Example (1). A is employed at a salary of $4,600 for the calendar year 1954. In the course of such employment, he incurred travel expenses of $750 for which he was reimbursed during the year. Such items constitute his sole income for 1954. In such case the gross income is $5,350 but the amount of $750 is deducted from gross income in the determination of adjusted gross income and thus A's adjusted gross income for 1954 is $4,600. Hence, the adjusted gross income being less than $5,000, he may elect to pay his tax for 1954 under section 3. Similarly, in the case of an individual engaged in trade or business (excluding from the term "engaged in trade or business" the performance of personal services as an employee), there may be deducted from gross income in ascertaining adjusted gross income those expenses directly relating to the carrying on of such trade or business.

Example (2). If B has, as his only income for 1954, a salary of $5,800 and his spouse has no gross income, then B's adjusted gross income is $5,800 (not $5,800 reduced by exemptions of $1,200) and he is not, for such year, entitled to pay his tax under section 3. If, however, B has for 1954 a salary of $6,500 and incident to his employment he incurs expenses in the amount of $1,700 for travel, meals, and lodging while away from home, the adjusted gross income is $6,500 minus $1,700, or $4,800. In such case his adjusted gross income being less than $5,000, B may elect to pay the tax under section 3. However, if B's wife has adjusted gross income of $200, the total adjusted gross income is $5,000. In such case, if B and his wife file a joint return, they may not elect to pay the optional tax since the combined adjusted gross income is not less than $5,000. B may nevertheless elect to pay the optional tax, but if he makes this election he must file a separate return and, since his wife has gross income, he may not claim an exemption for her in computing the optional tax.

(b) *Surviving spouse.*—The return of a surviving spouse is treated as a joint return for purposes of section 3. See section 2, and the regulations thereunder, with respect to the qualifications of a taxpayer as a surviving spouse. Accordingly, if the taxpayer qualifies as a surviving spouse and elects to pay the optional tax, he shall use the column

in the tax table, appropriate to his number of exemptions, provided for cases in which a joint return is filed.

(c) *Use of tax table.*—(1) To determine the amount of the tax, the individual ascertains the amount of his adjusted gross income, refers to the table set forth in section 3, ascertains the income bracket into which such income falls, and, using the number of exemptions applicable to his case, finds the tax in the vertical column having at the top thereof a number corresponding to the number of exemptions to which the taxpayer is entitled.

(2) The tax table in section 3 contains, in certain instances, double columns, in one of which is shown the tax if the taxpayer is single (and not the head of a household) or married and files a separate return, and in the other of which is shown the tax if the taxpayer is the head of a household. In other instances, such table contains triple columns, in the first of which is shown the tax if the taxpayer is single (and not the head of a household) or married and files a separate return, in the second of which is shown the tax if the taxpayer is the head of a household, and in the third of which is shown the tax if a joint return is filed. In the case of double or triple columns, the tax shall be determined by reference to the applicable column.

(3) The tax shown in the tax table set forth in section 3 reflects full income splitting in the case of a joint return (including the return of a surviving spouse) and lesser income splitting in the case of a head of household. Therefore, it is possible for the tax shown in the column relating to a joint return, or relating to a return of a head of a household, to be lower than that shown in the separate return column even though the amounts of adjusted gross income and the number of exemptions are the same. For example, if H, a married man, has adjusted gross income of $4,925 for the calendar year 1954 and his wife has no gross income the tax on a joint return basis would be $647 (assuming he is entitled to only two exemptions). If H files a separate return, claiming two exemptions (himself and his wife), his tax would be $671.

(4) The determination of the tax by use of the tax table set forth in section 3 may be illustrated by the following examples:

Example (1). Assume that A has adjusted gross income for the calendar year 1954 of $4,225, has two exemptions, and is single and not a head of a household. The tax is $533, which amount appears in the table under the first of the columns for two exemptions (designated for single taxpayers or married taxpayers filing separate returns) and opposite the appropriate income bracket $4,200 to $4,250) in the column showing adjusted gross income.

Example (2). Assume the same facts as in example (1) except that B qualifies as a head of a household. The tax is $527, which amount appears under the second of the columns for two exemptions (designated for a taxpayer who is a head of household) and opposite the appropriate income bracket ($4,200 to $4,250) in the column showing adjusted gross income.

§ 1.4 Statutory Provisions: Rules for Optional Tax.

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.

§ 1.4–1 NUMBER OF EXEMPTIONS.—(a) For the purpose of determining the optional tax imposed under section 3, the taxpayer shall use the number of exemptions allowable to him as deductions under section 151. See sections 151, 152, and 153, and the regulations thereunder. In general, one exemption is allowed for the taxpayer; one exemption for his spouse if a joint return is made, or if a separate return is made by the taxpayer and his spouse has no gross income for the calendar year in which the taxable year of the taxpayer begins and is not the dependent of another taxpayer for such calendar year; and one exemption for each dependent whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $600. No exemption is allowed for any dependent who has made a joint return with his spouse for the taxable year beginnig in the calendar year in which the taxable year of the taxpayer begins. The taxpayer may, in certain cases, be allowed an exemption for a dependent child of the taxpayer notwithstanding the fact that such child has gross income of $600 or more. Additional exemptions are allowed for a taxpayer or spouse who has attained the age of 65 years and for a blind taxpayer or blind spouse.

(b) The application of this section may be illustrated by the following examples:

Example (1). A, a married man whose duties as an employee require traveling away from his home, has as his sole gross income a salary of $5,600 for the calendar year 1954. His traveling expenses, including cost of meals and lodging, amount in such year to $750, and, hence, his adjusted gross income is $4,850. His wife, B, has as her sole income interest in the amount of $85, and thus the aggregate adjusted gross income of A and B is $4,935. A has

two dependent children, neither of whom has any income. A and B file a joint return for 1954 on Form 1040. In such case four exemptions are allowable. The adjusted gross income falls within the tax bracket $4,900–$4,950. By referring to such tax bracket in the tax table in section 3 and to the column headed "4" therein, the tax is found to be $407.

Example (2). C, a married man, has as his sole income in 1954 wages of $4,600, and has two dependent children neither of whom has any income. His wife, D, has adjusted gross income of $400. C files a separate return for 1954 and is entitled to claim three exemptions. C's income falls within the tax bracket $4,600–$4,650 and hence, with three exemptions his tax is $480. No exemption is allowed with respect to D since D has gross income and a joint return was not filed.

Example (3). D, a married man with no dependents, attains the age of 65 on September 1, 1954. The aggregate adjusted gross income of D and his wife for 1954 is $4,840. D and his wife file a joint return for 1954 and are entitled to three exemptions, one for each taxpayer and one additional exemption for D because of his age. Since the adjusted gross income of D and his wife falls within the tax bracket $4,800–$4,850, the tax on a joint return is $509.

§ 1.4–2 ELECTIONS.—(a) *Making of election.*—The election to pay the optional tax imposed under section 3 shall be made by (1) filing a return (whether a separate return or a joint return) on Form 1040A, or (2) filing a return (whether a separate return or a joint return) on Form 1040 and electing in such return, in accordance with the provisions of section 144 and the regulations thereunder, to take the standard deduction provided by section 141.

(b) *Election under section 3 and election of standard deduction.*—Section 144(a) and the regulations thereunder provide rules for treating an election to pay the tax under section 3 as an election to take the standard deduction, and for treating an election to take the standard deduction as an election to pay the tax under section 3. For example, if the taxpayer's return shows $5,000 or more of adjusted gross income and he elects to take the standard deduction, he will be deemed to have elected to pay the tax under section 3 if it is subsequently determined that his correct adjusted gross income is less than $5,000.

(c) *Head of household and surviving spouse.*—In the case of a head of a household (as defined in section 1(b) and the regulations thereunder) or a surviving spouse (as defined in section 2(b) and the regulations thereunder) electing to make his return on Form 1040A, the tax imposed by section 3 shall be computed without regard to the status of the taxpayer as the head of a household or as a surviving spouse. See section 6014 and the regulations thereunder.

(d) *Change of election.* For rules relating to a change of election to pay, or not to pay, the optional tax imposed under section 3, see section 144(b) and the regulations thereunder.

§ 1.4–3 HUSBAND AND WIFE FILING SEPARATE RETURNS.—(a) If the separate adjusted gross income of a husband is less than $5,000 and the separate adjusted gross income of his wife is less than $5,000, and if each is required to file a return, the husband and the wife both must,

or neither can, elect to pay the optional tax imposed under section 3. If the separate adjusted gross income of each spouse is $5,000 or more, then neither spouse can elect to pay the optional tax imposed under section 3. If the adjusted gross income of one spouse is $5,000 or more and that of the other spouse is less than $5,000, the election to pay the optional tax imposed under section 3 may be exercised by the spouse having adjusted gross income of less than $5,000 only if the spouse having adjusted gross income of $5,000 or more, in computing taxable income, uses the standard deduction provided by section 141. If the spouse having adjusted gross income of $5,000 or more does not use the standard deduction, then the spouse having adjusted gross income of less than $5,000 may not elect to pay the optional tax and must compute taxable income without regard to the standard deduction. Accordingly, if the spouse having adjusted gross income of $5,000 or more itemizes the deductions allowed by sections 161 and 211 in computing taxable income, the spouse having adjusted gross income of less than $5,000 must also compute taxable income by itemizing the deductions allowed by sections 161 and 211, and must pay the tax imposed by section 1. For rules relative to the election to take the standard deduction by husband and wife, see part IV of subchapter B (sections 141–145) and the regulations thereunder.

(b) For the purpose of applying the restrictions upon the right of a married person to elect to pay the tax under section 3, the determination of marital status is is made as of the close of the taxpayer's taxable year or, if his spouse died during such year, as of the date of death, and a person legally separated from his spouse under a decree of divorce or separate maintenance on the last day of his taxable year (or the date of death of his spouse, whichever is applicable) is not considered married. See section 143 and the regulations thereunder.

§ 1.4–4 Short Taxable Year Caused by Death.—An individual making a return for a period of less than 12 months on account of a change in his accounting period may not elect to pay the optional tax under section 3. However, the fact that the taxable year is less than 12 months does not prevent the determination of the tax for the taxable year under section 3 if the short taxable year results from the death of the taxpayer.

§ 1.5 Statutory Provisions; Cross References Relating to Tax on Individuals.

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 Limitation 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.

TAX ON CORPORATIONS

§ 1.11 STATUTORY PROVISIONS; 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, 1956.—In the case of a taxable year beginning before April 1, 1956, the normal tax is equal to 30 percent of the taxable income.

(2) TAXABLE YEARS BEGINNING AFTER MARCH 31, 1956.—In the case of a taxable year beginning after March 31, 1956, 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. 11 as amended by sec. 2, Tax Rate Extension Act, 1955.]

§ 1.11-1 TAX ON CORPORATIONS.—(a) Every corporation, foreign or domestic, is liable to the tax imposed under section 11 except (1) corporations described in section 11(d); (2) corporations expressly exempt from all taxation under subtitle A (see section 501); and (3) corporations subject to tax under section 511(a). For definition of the terms "corporation", "domestic", and "foreign", see section 7701(a)(3), (4), and (5), respectively. It is immaterial that a domestic corporation subject to the tax imposed by section 11 may derive no income from sources within the United States. The tax imposed by section 11 is payable upon the basis of returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income. See subchapter A of chapter 61 (sections 6001–6091, inclusive) and section 1442.

(b) The tax imposed by section 11 consists of a normal tax and a surtax. The normal tax and the surtax are both computed upon the taxable income of the corporation for the taxable year, that is, upon the gross income of the corporation minus the deductions allowed

by chapter 1. However, the deduction provided in section 242 for partially tax-exempt interest is not allowed in computing the taxable income subject to the surtax.

(c) The normal tax is computed by applying to the taxable income the rate of tax in effect for the taxable year. The rates of tax applicable for the respective taxable years are as follows:

	Percent
For taxable years beginning before April 1, 1956	30
For taxable years beginning after March 31, 1956	25

(d) The surtax is at the rate of 22 percent and is upon the taxable income (computed without regard to the deductions, if any, provided in section 242 for partially tax-exempt interest) in excess of $25,000. However, in certain circumstances the $25,000 exemption from surtax may be disallowed in whole or in part. See sections 269 and 1551 and the regulations thereunder.

(e) The computation of the tax on corporations imposed under section 11 may be illustrated by the following example:

Example. The X Corporation, a domestic corporation, has gross income of $86,000 for the calendar year 1955. The gross income includes interest of $5,000 on United States obligations for which a deduction under section 242 is allowable in determining taxable income subject to the normal tax. It has other deductions of $11,000. The tax of the X Corporation under section 11 for the calendar year 1955 is $32,000 ($21,000 normal tax and $11,000 surtax) computed as follows:

COMPUTATION OF NORMAL TAX

Gross income		$86,000
Deductions:		
Partially tax-exempt interest	$5,000	
Other	11,000	16,000
Taxable income		70,000
Normal tax (30% of $70,000)		21,000

COMPUTATION OF SURTAX

Taxable income	$70,000
Add: Amount of partially tax-exempt interest deducted in computing taxable income	5,000
Taxable income subject to surtax	75,000
Less: Exemption from surtax	25,000
Excess of taxable income subject to surtax over exemption	50,000
Surtax (22% of $50.000)	11,000

(f) For special rules applicable to foreign corporations engaged in trade or business within the United States, see section 882 and the regulations thereunder. For additional tax on personal holding companies, see part II of subchapter G (section 541 and following) and the regulations thereunder. For additional tax on corporations improperly accumulating surplus, see part I of subchapter G (section 531 and following) and the regulations thereunder. For treatment of China Trade Act corporations, see sections 941 and 942 and the regulations thereunder. For treatment of Western Hemisphere trade corporations, see sections 921 and 922 and the regulations thereunder. For

treatment of capital gains and losses, see subchapter P of chapter 1 (sections 1201–1241, inclusive). For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

§ 1.12 STATUTORY PROVISIONS; CROSS REFERENCES RELATING TO TAX ON CORPORATIONS.

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.

CHANGES IN RATES DURING A TAXABLE YEAR

§ 1.21 STATUTORY PROVISIONS; 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.

§ 1.21-1 CHANGES IN RATE DURING A TAXABLE YEAR.—(a) Section 21 applies to all taxpayers, including individuals and corporations. It provides a general rule applicable in any case where (1) any rate of tax imposed by chapter I upon the taxpayer is increased or decreased, or any such tax is repealed, and (2) the taxable year includes the effective date of the change, except where that date is the first day of the taxable year. Thus, for example, the normal tax on corporations is, under section 11(b), decreased from 30 percent to 25 percent in the case of a taxable year beginning after March 31, 1956. Accordingly, the tax for a taxable year of a corporation beginning on April 1, 1956, will be computed under section 11(b) at the new rate without regard to section 21. However, for any taxable year beginning before April 1, 1956, and ending on or after that date, the tax will be computed under section 21. For additional circumstances under which section 21 is not applicable, see § 1.21-1(k).

(b) In any case in which section 21 is applicable, a tentative tax shall be computed by applying to the taxable income for the entire taxable year the rate for the period within the taxable year before the effective date of change, and another tentative tax shall be computed by applying to the taxable income for the entire taxable year the rate for the period within the taxable year on or after such effective date. The tax imposed on the taxpayer is the sum of—

(1) An amount which bears the same ratio to the tentative tax computed at the rate applicable to the period within the taxable year before the effective date of the change that the number of days in such period bears to the number of days in the taxable year, and

(2) An amount which bears the same ratio to the tentative tax computed at the rate applicable to the period within the taxable year on and after the effective date of the change that the number of days in such period bears to the number of days in the taxable year.

(c) If the rate of tax is changed for taxable years "beginning after" or "ending after" a certain date, the following day is considered the effective date of the change for purposes of section 21. If the rate is changed for taxable years "beginning on or after" a certain date, that date is considered the effective date of the change for purposes of section 21. This rule may be illustrated by the following examples:

Example (1). Assume that the law provides that a change in a certain rate of tax shall be effective only with respect to taxable years beginning after March 31, 1956. The effective date of change for purposes of section 21 is April 1, 1956, and section 21 must be applied to any taxable year which begins before and ends on or after April 1, 1956.

Example (2). Assume that the law provides that a change in a certain rate of tax shall be applicable only with respect to taxable years ending after March 31, 1956. For purposes of section 21, the effective date of change is April 1, 1956, and section 21 must be applied to any taxable year which begins before and ends on or after April 1, 1956.

Example (3). Assume that the law provides that a change in a certain rate of tax shall be effective only with respect to taxable years beginning on or after January 1, 1956. The effective date

of change for purposes of section 21 is January 1, 1956, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1956.

(d) If a tax is repealed, the repeal will be treated as a change of rate for purposes of section 21, and the rate for the period after the repeal (for the purpose of computing the tentative tax in respect to that period) will be considered zero. However, section 21 does not apply to the imposition of a new tax. For example, if a new tax is imposed for taxable years beginning on or after July 1, 1955, a computation under section 21 would not be required with respect to such new tax in the case of taxable years beginning before July 1, 1955, and ending on or after that date. If the effective date of the imposition of a new tax and the effective date of a change in rate of such tax fall in the same taxable year, section 21 is not applicable in computing the taxpayer's liability for such tax for such year unless the new tax is expressly imposed upon the taxpayer for a portion of his taxable year prior to the change in rate.

(e) If a husband and wife have different taxable years because of the death of either spouse, and if a joint return is filed with respect to the taxable year of each, then, for purposes of section 21, the joint return shall be treated as if the taxable years of both spouses ended on the date of the closing of the surviving spouse's taxable year. See section 6013(c), relating to treatment of joint return after death of either spouse. Accordingly, if a change in the rate of tax is effective during the taxable year of the surviving spouse, the tentative taxes with respect to the joint return shall be computed on the basis of the number of days during which each rate of tax was in effect for the taxable year of the surviving spouse.

(f) Section 21 applies whether or not the taxpayer has a taxable year of less than 12 months. Moreover, section 21 applies whether or not the taxable income for a taxable year of less than 12 months is required to be placed on an annual basis under section 443. If the taxable income is required to be computed under section 443(b) then the tentative taxes under section 21 are computed as provided in paragraph (1) or (2) of section 443(b) and are reduced as provided in those paragraphs. The tentative taxes so computed and reduced are then apportioned as provided in section 21(a)(2) to determine the tax for such taxable year as computed under section 21.

(g) If a taxpayer has made the election under section 441(f) (relating to computation of taxable income on the basis of an annual accounting period varying from 52 to 53 weeks), the rules provided in section 441(f)(2) shall be applicable for purposes of determining whether section 21 applies to the taxable year of the taxpayer. Where a taxpayer has made the election under section 441(f) and where section 21 applies to the taxable year of the taxpayer the computation under section 21(a)(2) shall be made upon the basis of the actual number of days in the taxable year and each period thereof.

(h)(1) Section 21 is applicable only if a rate of tax imposed by chapter 1 changes. Sections in which rates of tax are specified or incorporated by reference include the following: 1, 2, 3, 11, 511, 531, 541, 871, 881, and 1201. Section 21 is not applicable with respect to changes in the law relating to deductions from gross income, exclu-

sions from or inclusions in gross income, or other items taken into account in determining the amount or character of income subject to tax. Moreover, section 21 is not applicable with respect to changes in the law relating to credits against the tax or with respect to changes in the law relating to limitations on the amount of tax. Section 21 is applicable, however, to all those computations specified in the section providing the rate of tax which are implicit in determining the rate. For example, if one of the tax brackets in section 1(b)(1) is changed, section 21 is applicable to that change. Thus, if the bracket relating to "over $50,000 but not over $60,000" should be changed to increase the last sum specified, with corresponding changes being made in subsequent brackets, section 21 is applicable. Another example would be if the $25,000 amount specified in section 11(c) were changed. Even though there were no other change in section 11(c), this change would be considered a change in rate.

(2) Ordinarily, both the old and the new rates are applied to the same amount of taxable income. However, where the rate of tax is itself taken into account in determining taxable income (for example, the special deduction for Western Hemisphere trade corporations under section 922), the taxable income used in determining the tentative tax employing the rate before the effective date of change shall be determined by reference to that rate of tax, and the taxable income for the purpose of determining the tentative tax employing the rate for the period on and after the effective date of the change shall be determined by reference to the new tax rate.

(i) If the rate of tax changes more than once during the taxable year, section 21 is applicable to each change in rate. For example, if the rate of normal tax changed for taxable years beginning on or after March 1, 1954, and changed again for taxable years beginning on or after June 1, 1954, section 21 requires computation of 3 tentative taxes for any taxable year which began before March 1, 1954, and ended on or after June 1, 1954: One tentative tax at the rate in effect before the March 1 change; another tentative tax at the rate in effect from March 1 to May 31; and a third tentative tax at the rate in effect from June 1 to the end of the taxable year. The proportion of each such tentative tax taken into account in determining the tax imposed on the taxpayer is computed by reference to the portion of the taxable year before March 1, 1954, by reference to the portion of the taxable year from March 1, 1954, through May 31, 1954, and by reference to the portion of the taxable year from June 1, 1954, to the end of the taxable year, respectively.

(j)(1) If a change in the rate of one tax imposed by chapter 1 does not affect the amount of other taxes imposed by chapter 1 the other taxes may be determined without regard to section 21 and section 21 will be applied only to the tax for which a change in rate is made. However, if the change of rate of one tax does affect the amount of other taxes imposed under chapter 1, then the computation of the taxes under chapter 1 so affected shall be made by applying section 21. For example, if section 1201 applies to an individual taxpayer for a taxable year containing the effective date of a change in a rate of tax provided in section 1, then under section 21 the taxpayer must compute a tentative tax for each period for which a different

rate of tax is effective under section 1. The tentative tax for each such period as computed under section 1201 will reflect the rate of tax provided by section 1 for such period.

(2) In certain cases chapter 1 provides that the particular tax to be imposed upon the taxpayer shall be one of several taxes, the basis of selection being the tax that is greater or lesser. See, for example, sections 821 and 1201. If in any such case the rate of any one of these taxes changes, then the tentative taxes computed as provided by section 21 for each period shall be computed employing the tax selected in accordance with the general rule of selection for such a case, at the rate of tax in effect for such period. Thus, if a change in the rate of the alternative tax under section 1201 is such that the alternative tax under section 1201 is applicable if the old rate is used and is not applicable if the new rate is used, one tentative tax will consist of the alternative tax under section 1201 and the other tentative tax will consist of the tax imposed by the other applicable sections of chapter 1. The two tentative taxes so computed are then prorated in accordance with section 21(a)(2) and the sum of the proportionate amounts is the tax imposed for the taxable year under chapter 1. See the examples in paragraph (n) of this section.

(k) Section 21 does not apply in the following two situations:

(1) Section 1201(a)(2), relating to the alternative tax for capital gains in case of a corporation, provides a different rate of tax for a taxable year beginning before April 1, 1954, than the rate of tax applicable to a taxable year beginning on or after April 1, 1954.

(2) The provisions of section 21 do not apply in the case of any taxpayer for taxable years beginning before January 1, 1954, and ending after December 31, 1953. For such taxable years, section 21 provides that section 108(j) of the Internal Revenue Code of 1939, relating to individuals, shall continue to be applicable, and the tax shall be computed at the rate and in the manner set forth in § 39.108–1 of Regulations 118 (26 CFR (1939) 39.108–1).

(l) In computing the number of days each rate of tax is in effect during the taxable year for purposes of section 21(a)(2), the effective date of the change in rate shall be counted in the period for which the new rate is in effect.

(m) Any credits against tax, and any limitation in any credit against tax, shall be based upon the tax computed under section 21. For credits against tax, see sections 31 to 38, inclusive.

(n) The application of section 21 may be illustrated by the following examples:

Example (1). A, an individual filing his return on a calendar year basis, has taxable income for the calendar year 1955, in the amount of $22,000 which includes $4,000 representing 50 percent of a long-term capital gain of $8,000. Assume, for the purpose of this example, that there has been no change in the rates of tax as shown in the tax tables under section 1(a), but the tax on capital gains under section 1201(b), relating to the alternative tax, has been increased from 25 percent to 35 percent and the effective date of the change in rate is July 1, 1955. The change in the rate of the capital gains tax affects a choice between the use of the tax table under section 1 and the alternative tax computation under section 1201(b). Accordingly, the first tentative tax would consist of the

alternative tax under section 1201(b) and the second tentative tax would consist of the normal tax and surtax as computed by the use of the tax table under section 1. The income tax for the taxable year ended December 31, 1955, would be computed under section 21 as follows:

FIRST TENTATIVE TAX

Taxable income (including 50% of long-term capital gain)	$22,000
Less: 50% of long-term capital gain	4,000
Amount taxable by use of tax table under section 1	$18,000
Tax on $18,000 (from tax table under section 1)	6,200
25% of long-term capital gain of $8,000	2,000
Total tentative tax at rates effective prior to change	$8,200

SECOND TENTATIVE TAX

Tax on $22,000 (from tax table under section 1)	$8,380
Total tentative tax at rates effective on and after effective date of change	8,380

Since the effective date of the change is July 1, the old rate of tax is effective for 181 days of the taxable year and the new rate of tax is effective for 184 days of the taxable year. The tentative taxes are apportioned as follows:

187/365 of $8,200 (the first tentative tax)	$4,066.30
184/365 of $8,380 (the second tentative tax)	4,224.44
Total tax for the taxable year	$8,290.74

Example (2). For purposes of this example, the following facts are assumed: The taxpayer is a corporation, its taxable year is the calendar year 1956, its taxable income for both normal tax and surtax purposes is $100,000, and it is subject to a change in the rate of the normal tax from 30 percent of taxable income to 25 percent of taxable income effective on April 1, 1956. The change in the normal tax rate applicable to the corporation does not affect the amount of any other tax applicable to the corporation under chapter 1. In such case, the tentative tax at the 30 percent rate would be $30,000, and the tentative tax at the 25 percent rate would be $25,000. The proportionate part of the tentative tax at the 30 percent rate is $7,431.69, that is, an amount which is the same proportion of $30,000 as 91 (the number of days from January 1 to March 31, 1956, both dates inclusive) is to 366 (the total number of days in the taxable year). The proportionate part of the tentative tax at the 25 percent rate is $18,784.15, that is, an amount which is the same proportion of $25,000 as 275 (the number of days from April 1 to December 31, 1956, both dates inclusive) is to 366.

CREDITS AGAINST TAX

§ 1.31 STATUTORY PROVISIONS; TAX WITHHELD ON WAGES.

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.

§ 1.31–1 CREDIT FOR TAX WITHHELD ON WAGES.—(a) The tax deducted and withheld at the source upon wages under chapter 24 (or in the case of amounts withheld in 1954, under subchapter D of chapter 9 of the Internal Revenue Code of 1939) is allowable as a credit against the tax imposed by subtitle A of the Internal Revenue Code of 1954, upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer. For the purpose of the credit, the recipient of the income is the person subject to tax imposed under subtitle A upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a State recognized as a community property State for Federal tax purposes make separate returns, each reporting for income tax purposes one-half of the wages received by the husband, each spouse is entitled to one-half of the credit allowable for the tax withheld at source with respect to such wages.

(b) The tax withheld during any calendar year shall be allowed as a credit against the tax imposed by subtitle A for the taxable year of the recipient of the income which begins in that calendar year. If such recipient has more than one taxable year beginning in that calendar year, the credit shall be allowed against the tax for the last taxable year so beginning.

§ 1.31–2 CREDIT FOR "SPECIAL REFUNDS" OF EMPLOYEE SOCIAL SECURITY TAX.—(a) *In general.*—(1) In the case of an employee receiving wages from more than one employer during the calendar year, amounts may be deducted and withheld as employee social security tax with respect to more than $3,600 of wages received during the calendar year 1954, and with respect to more than $4,200 of wages received during a calendar year after 1954. For example, employee social security tax may be deducted and withheld on $5,000 of wages received by an employee during a particular calendar year if the employee is paid wages in such year in the amount of $3,000 by one employer and in the amount of $2,000 by another employer. Section 6413(c) (as amended by section 202 of the Social Security Amendments of 1954) permits, under certain conditions, a so-called "special refund" of the amount of employee social security tax deducted and withheld with respect to wages paid to an employee in a calendar year after 1954 in excess of $4,200 ($3,600 for the calendar year 1954) by reason of the employee receiving wages from more than one employer during the

calendar year. For provisions relating to the imposition of the employee tax and the limitation on wages, see with respect to the calendar year 1954, sections 1400 and 1426(a)(1) of the Internal Revenue Code of 1939 and, with respect to calendar years after 1954, sections 3101 and 3121(a)(1) of the Internal Revenue Code of 1954, as amended by sections 208(b) and 204(a), respectively, of the Social Security Amendments of 1954.

(2) An employee who is entitled to a special refund of employee tax with respect to wages received during a calendar year and who is also required to file an income tax return for such calendar year (or for his last taxable year beginning in such calendar year) may obtain the benefits of such special refund only by claiming credit for such special refund in the same manner as if such special refund were an amount deducted and withheld as income tax at the source. For provisions for claiming special refunds for 1955 and subsequent years in the case of employees not required to file income tax returns, see section 6413(c) and the regulations thereunder. For provisions relating to such refunds for 1954, see § 408.802 of Regulations 128 (26 CFR (1939) 408.802).

(3) The amount of the special refund allowed as a credit shall be considered as an amount deducted and withheld as income tax at the source under chapter 24 (or, in the case of a special refund for 1954, subchapter D of Chapter 9 of the Internal Revenue Code of 1939). If the amount of such special refund when added to amounts deducted and withheld as income tax exceeds the taxes imposed by subtitle A of the Internal Revenue Code of 1954, the amount of the excess constitutes an overpayment of income tax under subtitle A, and interest on such overpayment is allowed to the extent provided under section 6611 upon an overpayment of income tax resulting from a credit for income tax withheld at source. See section 6401(b).

(b) *Federal and State employees and employees of certain foreign corporations.*—The provisions of this section shall apply to the amount of a special refund allowable to an employee of a Federal agency or a wholly owned instrumentality of the United States, to the amount of a special refund allowable to an employee of any State or political subdivision thereof (or any instrumentality of any one or more of the foregoing), and to the amount of a special refund allowable to employees of certain foreign corporations. See, with respect to such special refunds for 1954, section 1401(d)(4) of the Internal Revenue Code of 1939, and with respect to such special refunds for 1955 and subsequent years, section 6413(c)(2) of the Internal Revenue Code of 1954, as amended by section 202 of the Social Security Amendments of 1954.

§ 1.32 Statutory Provisions; Tax Withheld at Source on Nonresident Aliens and Foreign Corporations and on Tax-free Covenant Bonds.

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).

§ 1.33 Statutory Provisions; Taxes of Foreign Countries and Possessions of the United States.

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.

§ 1.34 Statutory Provisions; Dividends Received by Individuals.

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 years, 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.

§ 1.34–1 Credit Against Tax and Exclusion From Gross Income in Case of Dividends Received by Individuals.—(a) *In general.*—(1) Section 34 provides a credit against the income tax of an individual for certain dividends received after July 31, 1954. The credit, subject to the limitations provided in section 34(b), is equal to 4 percent of the dividends received. The credit is allowable with respect to dividends received in any taxable year ending after July 31, 1954. The credit applies only to dividends which are received from domestic corporations and which are included in the gross income of the taxpayer. Section 116 provides for the exclusion from gross income of the first $50 of certain dividends received by a individual. See § 1.116–1. In determining which dividends are entitled to the credit against income tax provided by section 34, the exclusion from gross income provided in section 116 is applied to the first dividends received in the taxable year. Since the exclusion applies to dividends received at any time during a taxable year ending after July 31, 1954, dividends received before August 1, 1954, may be taken into account in determining the exclusion from gross income under section 116 but do not constitute dividends for which a credit is allowed.

(2) The application of section 34 (without regard to the limitations provided in section 34(b)) may be illustrated by the following example:

Example. A, an individual who makes his return on the basis of the calendar year, receives in the year 1954 the following dividends: $100 on March 1, $100 on June 1, $100 on September 1, and $100 on December 1. $50 of the dividends received by A on March 1, 1954, is excluded from gross income under section 116. The balance of the dividends received in 1954, amounting to $350, is includible in the gross income of A. Subject to the limitation in section 34(b) a credit of $8 is allowed under section 34 (4 percent of $200, the amount of the dividends received after July 31, 1954, that is, $100 received on September 1, 1954, and $100 received on December 1, 1954).

(b) *Tax credit.*—The credit is used to reduce the tax imposed by subtitle A of the Internal Revenue Code of 1954, including the alternative tax under section 1201 in the case of capital gains and the self-employment tax under chapter 2 of the Internal Revenue Code of 1954; however, it may not be used by the taxpayer as a credit against penalties, additions to the tax, or interest on delinquent taxes.

(c) *Joint return of husband and wife.*—(1) In the case of a joint return the credit is determined on the basis of the dividends received by both the husband and wife after taking into account the exclusion allowed by section 116. See § 1.116–1. The credit is allowable in the case of a joint return on account of the dividends received by each spouse without regard to whether the spouse would be liable for the tax imposed by subtitle A if the joint return had not been filed. However, the limitations on amount of credit in section 34(b) are determined by reference to the tax and the credit under section 33 required to be shown on the joint return and to the combined taxable income of husband and wife. For this purpose, it makes no difference whether the tax, the credit, or the taxable income is attributable to one or the other spouse. If both the husband and wife are entitled to the credit, their combined credit shall not exceed the amount so computed.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). H and W, husband and wife, make a joint return for the calendar year 1954. The only dividend received by either of them during the year is a dividend received by H on September 1 in the amount of $400. Subject to the limitations of section 34(b), the credit amounts to $14 (4 percent of $350, the dividends included in gross income after allowance of the exclusion of $50 under section 116).

Example (2). The facts are the same as in example (1) except that W also received a dividend on September 1 of $30. Since this dividend (being less than the maximum amount allowable as an exclusion under section 116(a)) is excluded from W's gross income, it does not affect the computation of the tax credit and the tax credit is the same as in example (1).

Example (3). H and W, husband and wife, make a joint return for the calendar year 1954. H and W each received a $400 dividend on September 1, 1954, and these were the only dividends received by them in 1954. Since H and W may each exclude $50 of the dividends received by them, $700 of dividend income is included in gross income. Subject to the limitations in section 34(b), the credit against the tax of H and W amounts to $28 (4 percent of $700).

(d) *Individuals receiving dividends.*—Where two or more persons hold stock as tenants in common, as joint tenants, or as tenants by the entirety, the dividends received with respect to such stock shall be considered as being received by each tenant to the extent that he is entitled under local law to a share of such dividends. Where dividends constitute community property under local law each spouse shall be considered as receiving one-half of such dividends.

(e) *Time dividends are received.*—In cases where it is necessary to determine the time of receipt of dividends, the rules established to determine in which taxable year dividends must be included in gross income apply, including the rules relating to constructive receipt. See section 451 and regulations thereunder.

§ 1.34–2 Limitations on Amount of Credit.—(a) Under section 34(b) the credit may not exceed the lesser of either—

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

(2) Whichever of the following is applicable:

(i) In the case of a taxable year ending before January 1, 1955, 2 percent of the taxable income for such taxable year;

(ii) In the case of a taxable year ending after December 31, 1954, 4 percent of the taxable income for such taxable year.

In the case of a taxpayer who computes his tax under section 3 or who uses the standard deduction provided by section 141, the taxable income for the taxable year is the adjusted gross income for the taxable year reduced by the standard deduction prescribed in section 141 and the deductions for personal exemptions provided in section 151. Where the alternative tax on capital gains is imposed under section 1201(b), the taxable income for such taxable year is the taxable income reduced

by 50 percent of the excess of net long-term capital gain over net short-term capital loss.

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

Example: Assume the following facts in the case of an individual whose taxable year is the calendar year:

1954

Computation of tax liability without regard to the dividend received credit:	
(1) Gross income	$7,500
(2) Deductions	2,900
(3) Taxable income	4,600
(4) Income tax liability	996
(5) Foreign tax credit	16
(6) Income tax liability minus foreign tax credit	980
Computation of limitation under section 34(b)(1):	
(7) Dividends for which credit is allowable	$2,500
(8) Dividends received credit under section 34(a); (2,500×.04)	100
(9) Dividends received credit, as limited by section 34(b)(1); (item (6) or item (8) whichever is lesser)	100
Computation of limitation under section 34(b)(2):	
(10) Taxable income	$4,600
(11) Dividends received credit under section 34(b)(2); (4,600×.02)	92
Dividends received credit allowable:	
Item (6), item (9), or item (11), whichever is lesser	92

1955

Computation of tax liability without regard to the dividend received credit:	
(12) Gross income	$7,500
(13) Deductions	2,900
(14) Taxable income	4,600
(15) Income tax liability	996
(16) Foreign tax credit	816
(17) Income tax liability minus foreign tax credit	180
Computation of limitation under section 34(b)(1):	
(18) Dividends for which credit is allowable	$2,500
(19) Dividends received credit under section 34(a); (2,500×.04)	100
(20) Dividends received credit as limited by section 34(b)(1); (item (17) or item (19) whichever is lesser)	100
Computation of limitation under section 34(b)(2):	
(21) Taxable income	$4,600
(22) Dividends received credit under section 34(b)(2); (4,600×.04)	184
Dividends received credit allowable:	
Item (17), item (19), or item (22), whichever is lesser	100

§ 1.34–3 DIVIDENDS TO WHICH THE CREDIT AND EXCLUSION APPLY.—(a) *General rule.*—The credit under section 34 and the exclusion under section 116 apply only to distributions of property defined as dividends by section 316. Thus, the credit and the exclusion are not allowed with respect to patronage dividends paid by either exempt or taxable farm cooperatives. Nor are they allowed for distributions to nonstockholding policyholders by an insurance company having shares of stock or for any distribution by a mutual insurance company.

See paragraph (b) of this section for an additional restriction with respect to stock life insurance companies. The credit and the exclusion are, however, allowed with respect to dividends paid on capital stock by nonexempt cooperatives and with respect to dividends paid on capital stock by building and loan associations. However, see paragraph (b) of this section with respect to so-called dividends paid by building and loan associations ineligible for the credit and the exclusion. The credit and the exclusion are allowed with respect to distributions from any organization taxed as a corporation if the distribution falls within the definition of a dividend in section 316.

(*b*) *Dividends from certain corporations.*—(1) Section 34(c) and (d) contains further restrictions on the type of distributions which are treated as dividends for purposes of the credit and exclusion. Thus, no credit or exclusion is applicable with respect to dividends received from a corporation organized under the China Trade Act, 1922; from stock life insurance companies; from corporations which during their taxable year of the distribution or their preceding taxable year were corporations to which section 931 applies (relating to income from sources within possessions of the United States); from corporations which during the taxable year of the distribution or the preceding taxable year are corporations exempt from tax either under section 501, relating to charitable, etc., organizations, or under section 521, relating to farmers' cooperative associations.

(2) So-called dividends paid by mutual savings banks, cooperative banks, and building and loan associations which are allowed as a deduction under section 591 are ineligible for the credit and exclusion.

(3) For special rules as to the limitation on the amount of dividends for which a credit and exclusion are allowable in the case of dividends paid by a regulated investment company, see section 854 and the regulations thereunder.

§ 1.34–4 Taxpayers Not Entitled to Credit and Exclusion.—(a) The credit or exclusion is not available to nonresident aliens with respect to whom a tax is imposed for the taxable year under section 871(a). If the taxpayer elects under section 6014 to have the Government compute his tax, the credit is not taken into account in such computation although the taxpayer is allowed the exclusion under section 116.

(b) For treatment of dividends received by estates or trusts, and the allocation of such dividends between an estate or trust and the beneficiary thereof, see sections 642, 652, and 662 and the regulations thereunder.

(c) For treatment of dividends received by a partnership, see section 702 and the regulations thereunder.

(d) For treatment of dividends received by a common trust fund, see section 584 and the regulations thereunder.

§ 1.34–5 Effective Date; Taxable Years Ending After July 31, 1954, Subject to the Internal Revenue Code of 1939.—Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.34–1 to § 1.34–4, inclusive, shall also apply to taxable years beginning before January 1, 1954, and ending after July 31, 1954, and to taxable years beginning after December 31, 1953, and ending after July 31, 1954, but before August 17, 1954, though such years are subject to the Internal Revenue Code of 1939.

§ 1.35 STATUTORY PROVISIONS; PARTIALLY TAX-EXEMPT INTEREST RECEIVED BY INDIVIDUALS.

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.

§ 1.35–1 PARTIALLY TAX-EXEMPT INTEREST RECEIVED BY INDIVIDUALS.—(a) The credit against tax under section 35 shall be allowed only to individuals and if the requirements of both paragraphs (1) and (2) of section 35(a) are met. Where the alternative tax on capital gains is imposed under section 1201 (b), the taxable income for such taxable year is the taxable income reduced by 50 percent of the excess of net long-term capital gain over net short-term capital loss.

(b) For the treatment of partially tax-exempt interest in the case of amounts not allocable to any beneficiary of an estate or trust, see section 642(a)(1), and for treatment of amounts allocable to a beneficiary, see sections 652 and 662. For treatment of partially tax-exempt interest received by a partnership, see section 702(a)(7). For treatment of such interest received by a common trust fund, see section 584(c)(2).

(c) The application of section 35 may be illustrated by the following example:

Example. In his taxable year, 1955, A received $4,500 of partially tax-exempt interest. A's taxable income is $4,000 upon which the tax prior to any credits against tax is $840. His foreign tax credit under section 33 is $610, and his dividends received credit under section 34 is $120. A's credit under section 35 for partially tax-exempt interest is $110, determined as follows:

Section 53(a)

Partially tax-exempt interest	$4,500
Credit computed under section 35(a)(); 3 percent of $4,500	135

Section 35(b)(1)

Tax imposed by chapter 1		$840
Less: Credit allowed under section 33	$610	
Credit allowed under section 34	120	730
Limitation on credit under section 35(b)(1)		$110

Section 35(b)(2)

Taxable income	$4,000
Limitation on credit under section 35(b)(2); 3 percent of $4,000	120

Since of the three figures ($135, $110, and $120), the lesser is $110, A's credit under section 35 is limited to $110.

§ 1.36 Statutory Provisions; Credit Not Allowed to Individuals Paying Optional Tax or Taking Standard Deduction.

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.

§ 1.37 Statutory Provisions; Retirement Income.

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.

(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. 37 as amended by Public Law 299 (84th Cong.) for taxable years beginning after December 31, 1954. For taxable years beginning before January 1, 1955, sec. 37(f) contains "; 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" after the words "District of Columbia"]

§ 1.37-1 ALLOWANCE OF CREDIT FOR RETIREMENT INCOME.—(a) Section 37 provides a credit against the tax imposed by chapter 1 of the Internal Revenue Code of 1954 in the case of an individual who receives in the taxable year retirement income as defined in section 37(c) and who meets the eligibility requirements of section 37(b). The amount of the credit is determined by multiplying the amount of retirement income, as limited by section 37(d), by the rate of tax applicable under section 1 to the first $2,000 of taxable income. Thus, if the retirement income is $1,000, the retirement income credit so computed is, at the present tax rate for the first $2,000 of taxable income, 20 percent of $1,000, or $200. The credit cannot exceed, however, the tax imposed by chapter 1, reduced by the credits enumerated in section 37(a).

(b) Section 37(d) provides that the amount of retirement income with respect to which the retirement income credit is allowable can in no event exceed $1,200. Thus, the maximum credit for an individual cannot exceed $240 so long as section 1 provides a 20 percent rate for the first $2,000 of taxable income. If section 1 should be amended to change this rate, the amount of the credit and the maximum amount of credit would be changed accordingly.

(c)(1) Section 37(a) provides that the amount of the retirement income credit shall not be greater than the excess of the individual's tax under chapter 1 for the taxable year over the sum of his credits against tax 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).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Assume that the individual has a retirement income credit of $240 before applying the limitation in section 37(a), and

has the tax liability shown in (i) below, and the credits shown in (ii) and (vi).

(i) Tax under chapter 1	$300
(ii) Sum of credits allowable under sections 32(2), 33, 34, and 35	100
(iii) Tax reduced by credits in (ii)	200
(iv) Retirement income credit under section 37(a) ($240 or $200 whichever is lesser)	200
(v) Tax under chapter 1 as further reduced by credit in (iv)	0
(vi) Credit for tax withheld at source on wages under section 31	35
(vii) Overpayment of tax	$35

(d)(1)(i) In the case of a joint return of husband and wife, a separate determination is made with respect to the eligibility of each spouse for the retirement income credit, and (with the exceptions described in subdivision (ii) of this subparagraph) the retirement income credit of each spouse eligible for such credit is separately computed.

(ii) The retirement income credit is allowable in the case of a joint return on account of the retirement income of each spouse without regard to whether the spouse would be liable for the tax imposed by chapter 1 if the joint return had not been filed. For example, if the wife's only income consists of $500 of retirement income, and if she is eligible for the credit, the retirement income credit is allowable with respect to such retirement income in case a joint return is filed. However, the limitation in section 37(a) on the amount of the credit is determined by reference to the tax and the credits under sections 32(2), 33, 34, and 35, required to be shown on the joint return. For this purpose, it makes no difference whether the tax or the credits are attributable to one or the other spouse. If both the husband and wife are entitled to a retirement income credit, their combined retirement income credit shall not exceed the amount so computed.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). Assume the same facts as in the example in paragraph (c), except that the return is a joint return, the retirement income credit is based on the retirement income of the husband only, the wife has no retirement income, and 90 percent of the amount shown as the tax under chapter 1 and the credits under sections 31, 32(2), 33, 34, and 35 are attributable to the wife. The retirement income credit on the joint return is limited to $200, computed in exactly the same manner as shown in the example in paragraph (c).

Example (2). Assume the same facts as in example (1) above, except that in addition the wife has a retirement income credit of $160 computed before applying the limitation in section 37(a). Accordingly, the combined retirement income credit without regard to the limitation in section 37(a) is the sum of $240 and $160, or $400. The combined retirement income credit allowable on the

joint return after applying the limitation in section 37(a) is $200, computed in exactly the same manner as shown in the example in paragraph (c).

(e) If retirement income constitutes community income under community property laws applicable to such income, the retirement income credit of each spouse shall be separately computed by taking into account one-half of such amounts. If the husband and wife file a joint return, the limitation in section 37(a) on the amount of the combined retirement income credit is determined in the manner provided in paragraph (d) of this section. See § 1.37-2 for eligibility requirements that must be met by each spouse.

(f) If the taxpayer elects under section 6014 to have the Government compute his tax, the retirement income credit is not taken into account in such computation.

§ 1.37-2 Eligibility for Retirement Income Credit.—(a) In order to be eligible for the retirement income credit, section 37(b) provides that the taxpayer must have received earned income in excess of $600 during each of any 10 calendar years preceding the taxable year. For the purposes of section 37(b) and section 37(d)(2), the term "earned income" has the same meaning as in section 911(b), except that earned income does not include any amount received as a pension or annuity. See section 911(b) and the regulations thereunder. Section 911 (b) provides, in general, that earned income includes wages, salaries, professional fees, and other amounts received as compensation for personal services rendered. For the purposes of section 37(b) and section 37(d)(2), earned income means the entire amount of such income and shall not be reduced by any expenses connected with the earning of such income. Also, for such purposes, income earned by either spouse which constitutes community income under community property laws applicable to such income shall be treated as earned income received one-half by each spouse.

(b) An individual who is a nonresident alien at any time during the taxable year is not eligible for the retirement income credit for such taxable year.

(c) For purposes of determining eligibility, the 10 calendar years must occur before the beginning of the taxable year for which the credit is allowable. If the taxable year is a fiscal year, the calendar year in which such taxable year begins may not be included as one of the 10 calendar years. The 10 calendar years need not immediately precede the taxable year, need not be consecutive, and need not include years subject to the income tax laws. The 10 calendar years may include years for which the taxpayer was exempt from income tax, and may include years for which the taxpayer was not required to file an income tax return or had no income subject to tax, for example, a calendar year during which the individual's income was less than his personal exemption, or a calendar year for which an individual's earned income was excluded from gross income under section 911(a) or the corresponding provisions of prior revenue laws.

(d)(1) If a husband or wife dies, the earned income which the deceased spouse received in any calendar year shall be treated as earned income of the surviving spouse for such calendar year for the purpose of determining the eligibility of the surviving spouse for the retirement income credit. In any case in which the deceased spouse was

eligible for the retirement income credit for the taxable year ending with his death, the surviving spouse will be deemed to have received earned income of more than $600 for 10 calendar years for the purpose of determining the eligibility of the surviving spouse. Thus, in such case, the deceased spouse is allowed a retirement income credit for the retirement income which he received during the taxable year ending with his death, and the surviving spouse is allowed a retirement income credit for the retirement income which she received during her taxable year in which he died, whether joint returns or separate returns are filed. (See, however, paragraph (c) for additional requirement where the taxable year of the surviving spouse is a fiscal year.) If the year of death of the deceased spouse constitutes the tenth year in which he received earned income of more than $600, the deceased spouse is not eligible for the retirement income credit and the surviving spouse will not be deemed to meet the eligibility requirement (solely by virtue of the earned income received by her deceased spouse) for any taxable year prior to her first taxable year beginning in a calendar year subsequent to the calendar year in which he died.

(2) An example of the application of the rule with respect to earned income of a surviving spouse is as follows:

Example. The only earned income of the deceased spouse and the surviving spouse was as follows:

Calendar Year	*Earned income of deceased spouse*	*Actual earned income of surviving spouse*	*Earned income of surviving spouse for purpose of section 37(b)*
(1) 1940	$650	---	$650
(2) 1942	800	---	800
(3) 1943	900	---	900
(4) 1944	650	---	650
(5) 1946	650	---	650
(6) 1948	400	$300	700
(7) 1950	600	800	1,400
(8) 1951	---	800	800
(9) 1952	---	650	650
(10) 1954	---	650	650

(e) For the purpose of the rule described in paragraph (d) of this section, it makes no difference when the deceased spouse received the earned income. For example, the surviving spouse is treated as receiving earned income for every year in which the deceased spouse received such income, even though they were not yet married. Furthermore, for purposes of this rule, the earned income received by the deceased spouse during the calendar year in which he died is treated as the earned income of the surviving spouse for such calendar year.

(f) If an individual has married more than once, the status of the individual as a surviving spouse is, for purposes of section 37(b) and of the rule described in paragraph (d), determined only by reference to his most recent marriage. An individual is not a surviving spouse of a decedent if they were divorced. If the surviving spouse remarries, he may not determine his eligibility for the retirement income credit for the taxable year in which he remarries or for any subsequent taxable year by treating the earned income of the decedent as his own earned income. If his second spouse dies and the taxpayer does not again remarry, he may apply the rule described in paragraph (d) of this section with respect to his second deceased spouse only.

If the second marriage is terminated by divorce rather than by death of the spouse, the taxpayer does not regain the status of being a surviving spouse of the first deceased spouse.

§ 1.37-3 Retirement Income—(a) *Inclusions in retirement income.*—(1) *General rule.*—Income which may be treated as the retirement income of an individual who is 65 years of age or older at the close of the taxable year is determined under section 37(c)(1). If the individual has not attained the age of 65 at the close of the taxable year, his retirement income for the taxable year is determined under section 37(c)(2). See paragraph (b) of this section for the exclusion from retirement income of certain portions of the income described in paragraph (1) or (2) of section 37 (c), whichever is applicable to the individual. See also section 37(d) and § 1.37-4 for limitations on the amount of retirement income with respect to which the retirement income credit is computed.

(2) *Individuals 65 or over at the close of taxable year.*—In the case of individuals who have attained the age of 65 before the close of the taxable year, retirement income consists of income from pensions and annuities, interest, rents, and dividends, to the extent that such income is includible in gross income. Pensions and annuities include (but are not limited to) amounts received as such under a public retirement system or under a retirement system established for members of the Armed Forces of the United States. For the purpose of section 37(c)(1), income from rents shall be the gross amount received, not reduced by depreciation or other expenses. Retirement income does not include royalties as distinguished from rents.

(3) *Individuals under 65 at close of taxable year.*—In the case of individuals who have not attained the age of 65 before the close of the taxable year, retirement income consists only of income received as pensions and annuities from a public retirement system; that is, income from a pension, annuity, retirement, or similar fund or system established by the United States, a State or Territory, a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia. However, for taxable years beginning before January 1, 1955, a public retirement system does not include a fund or system established by the United States for members of the Armed Forces of the United States.

(b) *Exclusion from retirement income.*—(1) *Compensation for personal services rendered during taxable year.*—Retirement income may not include any amount representing compensation for personal services rendered during the taxable year. For this purpose, amounts received as a pension shall not be treated as representing compensation for personal services rendered during the taxable year if the period of service during the taxable year is not substantial when compared with the total years of services. For example, an individual on the calendar year basis retires on November 30 after 5 years of service and receives a pension during the remainder of his taxable year. The pension is not treated as representing compensation for personal services rendered during such taxable year merely because it is paid by reason of the services of the individual for a period of 5 years which includes a portion of the taxable year. In the case of amounts received for board and lodging, the portion of the amount received for board may not be included in retirement income.

(2) *Amounts not includible in gross income.*—Retirement income may not include any amount not includible in the gross income of the individual for the taxable year. For example, if a portion of an annuity is excluded from gross income under section 72, relating to annuities, that portion of the annuity is not retirement income; similarly, the portion of dividend income excluded from gross income under section 116, relating to the partial exclusion of dividends received by individuals, is not retirement income.

§ 1.37-4 Limitation on Amount of Retirement Income.—(a) Section 37(d) provides a limitation on the amount of retirement income with respect to which the retirement income credit is allowable. Such credit is computed on the amount of retirement income, as defined in section 37(c), but on not more than the amount determined as the limitation provided by section 37(d). In any event, the maximum amount of retirement income with respect to which the retirement income credit is allowable is $1,200. The limitation provided by section 37(d) is determined by subtracting from $1,200 the sum of the amounts received during the taxable year as—

(1) A pension or annuity under title II of the Social Security Act;

(2) A pension or annuity under the Railroad Retirement Acts of 1935 or 1937;

(3) Any other pension or annuity which is excludible from gross income, such as pensions received under laws relating to veterans; and

(4) In the case of an individual who has not attained the age of 75 before the close of the taxable year, earned income in excess of $900.

(b) In determining the limitation of section 37(d), the following additional rules shall be applicable:

(1) No reduction shall be made on account of any amounts excluded from gross income because of the application of section 72 (relating to annuities), section 101 (relating to life insurance proceeds), section 104 (relating to compensation for injuries or sickness), section 105 (relating to amounts received under accident and health plans), section 402 (relating to taxability of beneficiary of employees' trust), or section 403 (relating to taxation of employee annuities).

(2) No reduction for earned income shall be made in the case of an individual who has attained the age of 75 before the close of his taxable year.

(3) The term "earned income" has the same meaning as in § 1.37-2(a). (However, the special rule relating to widows and widowers contained in section 37(b) is not applicable in determining the limitation of section 37 (d).)

(4) Where the amounts designated in paragraph (a) (1) to (4) of this section are treated as community income under community property laws applicable with respect to such income, such amounts shall be treated as received one-half by each spouse.

(5) In no event can the sum of the amounts designated in paragraph (a) (1) to (4) of this section reduce the amount of the retirement income, or the credit with respect thereto, to less than zero.

(c) The determination of the limitation of section 37(d) may be illustrated by the following example:

Example. If an individual eligible for the retirement income credit, age 70, receives as his only income during his taxable year, $200 of interest and $1,700 as compensation for personal services rendered by him during the year, such individual is entitled to a retirement income credit computed on the $200 of interest. The limitation of section 37(d) is determined by subtracting from $1,200, $800, the amount of earned income in excess of $900. Since the limitation is thus $400, the credit is computed on the entire amount of retirement income (the interest item of $200). However, if the individual had received interest in excess of $400, the retirement income credit would have been computed on only $400.

§ 1.37–5 Illustration of Application of Section 37.—The application of section 37 may be illustrated by the following example:

Example. Assume that an individual eligible for the retirement income credit, 70 years of age, unmarried, computing his tax under section 3, has the following items of income for the calendar year 1954:

Dividend income received after July 31, 1954 (of which $50 is excluded from gross income under section 116)	$750
Pension under the Railroad Retirement Act of 1937 (entirely excluded from gross income)	600
Disability payments under a workmen's compensation act (entirely excluded from gross income under section 104)	400
Rental income	600
Earned at odd jobs	1,300

First, the taxpayer must compute his tax before the credit, as follows:

Adjusted gross income ($700 dividend income + $600 rental income + $1,300 earned income)	$2,600.00
Tax before any credit (determined by table in section 3)	230.00
Less dividend received credit under section 34	22.80
Tax before retirement income credit	207.20

Next, the taxpayer must compute his retirement income credit as follows:

Retirement income includes—	
Dividend income	$700
Rental income	600
Total retirement income	1,300

But the limitations in section 37(d) provide that this amount may not exceed a maximum amount determined as follows:

Maximum amount (before reduction)	$1,200
Less railroad retirement pension	600
	600
Less earned income in excess of $900	400
Amount of retirement income upon which the credit is computed	200

The retirement income credit is computed by applying the 20 percent rate to the maximum amount of retirement income reduced by the railroad retirement pension and the earned income in excess of $900, as follows:

Maximum amount of retirement income as reduced above	$200
20 percent rate	.20
Retirement income credit	40

§ 1.38 STATUTORY PROVISIONS; OVERPAYMENTS OF TAX.

SEC. 38. OVERPAYMENTS OF TAX.

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

COMPUTATION OF TAXABLE INCOME

ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

§ 1.116 STATUTORY PROVISIONS; PARTIAL EXCLUSION OF DIVIDENDS RECEIVED BY INDIVIDUALS.

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).

§ 1.116–1 PARTIAL EXCLUSION OF DIVIDENDS.—(a) Section 116 excludes from gross income the first $50 of dividends from domestic corporations received by an individual at any time during a taxable year which ends after July 31, 1954, whether or not the dividend is received after July 31, 1954.

(b) In the case of a joint return of husband and wife, each spouse is entitled to the exclusion (in an amount not in excess of $50) with

respect to the dividends received by such spouse. Thus, if in the calendar year 1955, a husband receives $200 of dividends and his wife $100, the amount to be included in gross income is $200 ($150 of the husband's dividends and $50 of the wife's dividends). If the wife receives only $30 of dividends, the entire $30 is excludable, and there is included in gross income in the joint return only $150 consisting of the dividends received by the husband ($200 less his $50 exclusion). For further examples illustrating the application of the exclusion, see § 1.34–1.

(c) Where two or more persons hold stock as tenants in common, as joint tenants, or as tenants by the entirety, the dividends received with respect to such stock shall be considered as being received by each tenant to the extent that he is entitled under local law to a share of such dividends. Where dividends constitute community property under local law each spouse shall be considered as receiving one-half of such dividends.

(d) For restrictions and limitations with respect to the type of dividends to which the exclusion is applicable, see § 1.34–3.

(e) For taxpayers not entitled to the exclusion, see § 1.34–4.

(f) The regulations with respect to determination of when dividends are received under section 34 apply also to section 116. See § 1.34–1(e).

§ 1.116–2 Effective Date; Taxable Years Ending After July 31, 1954, Subject to the Internal Revenue Code of 1939.—Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.116–1 shall also apply to taxable years beginning before January 1, 1954, and ending after July 31, 1954, and to taxable years beginning after December 31, 1953, and ending after July 31, 1954, but before August 17, 1954, though such years are subject to the Internal Revenue Code of 1939.

Russell C. Harrington,
Commissioner of Internal Revenue.

Approved: January 31, 1956.

H. Chapman Rose,
Acting Secretary of the Treasury.

(Filed by the Division of the Federal Register, February 3, 1956, 8:48 a. m.)

PART IV.—CREDITS AGAINST TAX

SECTION 34.—DIVIDENDS RECEIVED BY INDIVIDUALS

26 CFR 1.34–1: Credit against tax and exclusion from gross income in case of dividends received by individuals. (Also Section 116; 1.116–1.) — Rev. Rul. 56–233

For the purpose of determining whether a dividend was received after July 31, 1954, in order to compute the credit and the partial exclusion with respect to dividends received by an individual partner, the date on which the dividends were received by the partnership constitutes the date of their receipt by the partner.

Advice has been requested as to the dividend credit and exclusion, under sections 34 and 116 of the Internal Revenue Code of 1954, allowable to members of a partnership with respect to dividends received by the partnership.

Under the Internal Revenue Code of 1939, the character of any item of income realized by a partnership and included in a partner's distributive share is the same as though the partner had realized such item directly from the source from which it was realized by the partnership and in the same manner. See *Harry H. Neuberger* v. *Commissioner*, 311 U. S. 83, Ct. D. 1470, C. B. 1940–2, 228; *Emil Mosbacher* v. *United States*, 311 U. S. 619; *Commissioner* v. *Jack Jordon Ammann et ux.*, 228 Fed. (2d) 417; *Zelda B. Jennings et al.* v. *Commissioner*, 110 Fed. (2d) 945, certiorari denied, 311 U. S. 704; *John Craik* v. *United States*, 31 Fed. Supp. 132; G. C. M. 22491, C. B. 1941–1, 374; and G. C. M. 22461, C. B. 1941–1, 295. Section 702(b) of the Internal Revenue Code of 1954 enacts the same rule for taxable years to which Subchapter K thereof, relating to partners and partnerships, is applicable. See the Senate Finance Committee Report on section 702 (83d Congress, 2d Session, Senate Report No. 1622, 376). The position expressed in the case of *John E. Dockendorff* v. *United States*, 84 Fed. Supp. 372, is not consistent with this rule and will not be accepted by the Internal Revenue Service in the disposition of other cases involving similar factual situations.

Accordingly, a member of a partnership who reports his income for a taxable year ending after July 31, 1954, must include in his return for such year his distributive share of the partnership income for its taxable year ending with or within his taxable year and compute the dividend credit and exclusion allowed by sections 34 and 116 of the Internal Revenue Code of 1954 with respect to dividends received by the partnership, to which such credit and exclusion apply, in the same manner as if these dividends had been received in his individual capacity; and, for the purpose of determining, under sections 34 and 116 of the Code, whether a dividend was received after July 31, 1954, and in a taxable year of the partner ending after July 31, 1954, the date on which the dividend was received by the partnership is to be treated as the date of its receipt by the partner.

SECTION 37.—RETIREMENT INCOME

Rev. Rul. 56–12

For the purpose of determining the income tax credit upon retirement income, a pension received as a gift constitutes a pension within the meaning of section 37 of the Internal Revenue Code of 1954. A gift pension does not fall within any of the exceptions of excluded income provided by section 37(e) of the Code in the application of section 37(d)(1) of the Code in determining the limitation on retirement income, and the amount thereof must be used to reduce the retirement income.

Advice has been requested whether a pension received as a gift from one for whom no personal services have been performed constitutes a pension or annuity to be taken into account in computing the limita-

tion on retirement income under section 37(d) of the Internal Revenue Code of 1954.

A foundation for the advancement of teaching was established for the purpose of paying gratuitous allowances to retired college teachers and their widows. Such allowances were intended as gifts to persons who have performed no services of any kind for the founder and, as gifts, have been held to be excludable from gross income.

Section 37(d) of the Code provides in part that for the purpose of the credit the amount of retirement income shall not exceed $1,200 less—

> (1) in the case of an individual, any amount received by the individual as a pension or annuity—
>
> * * * * * * *
>
> (C) otherwise excluded from gross income, * * *.

Section 37(e) of the Code provides that the term "otherwise excluded from income" shall not apply to any amount excluded 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).

Section 37(d) of the Code does not specify that the meaning of the word pension refers to periodic payments made by or on behalf of a person for whom services have been rendered. In referring to items which serve to reduce the amount of retirement income, section 37(d) specifically includes "any amount received by the individual as a pension or annuity * * * otherwise excluded from gross income." Although the first test of the qualification for the retirement income credit is that the individual must have received earned income of over $600 in ten calendar years prior to the taxable year, it does not necessarily follow that the same qualification should apply in obtaining the pensions which are required to reduce the retirement income.

In discussing the term "pension" in L. O. 1040, 3 C. B. 120 (1920), it is stated:

> The fact that the payments involved in the instant case take the form of pensions and are within the dictionary definition of the term "pension" does not, as seems to have been suggested, take them out of the definition of the term "gift." The term "pension" and "gift" are not mutually exclusive. The payments may be both pensions and gifts.

In instituting section 37 of the Code, it was the intent of Congress to equalize the tax treatment of all kinds of retirement income. See Report No. 1622 of the Committee on Finance of the United States Senate to accompany H. R. 8300, at pages 8, 165 and 166. The type of pension or annuity referred to in section 37(d)(1)(C) is not specified or limited except insofar as section 37(e) of the Code is applicable.

Accordingly, it is held that for the purpose of determining the income tax credit upon retirement income a pension received as a gift constitutes a pension within the meaning of section 37 of the Internal Revenue Code of 1954. A gift pension does not fall within any of the exceptions of excluded income provided by section 37(e) of the Code in the application of section 37(d)(1) of the Code in determining the limitation on retirement income, and the amount thereof must be used to reduce the retirement income.

(Also Section 104.) Rev. Rul. 56-42

Retirement income, for the purpose of the credit provided by section 37 of the Internal Revenue Code of 1954, is not to be reduced by the amount of the death compensation paid by the Veterans' Administration to the widow of a veteran whose death in service or after discharge or retirement was due to service rendered during a war.

Advice has been requested whether retirement income should be reduced by the amount of the death compensation paid by the Veterans' Administration to a widow of a veteran whose death in service or after discharge or retirement was due to service rendered during a war.

The taxpayer in the instant case received a survivor's annuity from her husband's civil service retirement and $87 a month from the Veterans' Administration as the fixed amount of death compensation payable to the childless widow of a veteran whose death, either in service or after discharge or retirement, was due to wartime service.

Section 37 of the Internal Revenue Code of 1954 allows an individual, who has received earned income in excess of $600 in each of ten prior calendar years, to take as a credit against the tax computed on his return for the taxable year an amount equal to the amount received as retirement income (as defined in subsection (c) and limited by subsection (d)), multiplied by the first bracket rate of tax (20 percent under the present law), but this credit may not exceed the tax shown on the return reduced by certain credits. A widow whose husband had received such earned income during prior years shall be considered to have received earned income.

Section 37 of the Code provides in part as follows:

(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, * * *

* * * * * * *

(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).

The death benefits received by the taxpayer are tax exempt and the basic problem that arises is whether they are payments of a pension or annuity excluded from gross income within the meaning of section 37(d)(1)(C) of the Code and outside the scope of the exceptions contained in section 37(e) of the Code.

The legislative history of the retirement income credit provisions of the Code indicates that Congress intended to prevent the duplication of retirement income benefits in the enactment of sections 37(d)(1) and 37(e). The Report of the Committee on Finance, United States Senate, No. 1622, Eighty-third Congress, Second Session, page 8, to accompany H. R. 8300, furnishes a general characterization of the purposes of section 37(d)(1) of the Code as follows:

Since some types of retirement pensions are already excluded from gross income, an adjustment is made to avoid duplication. The amount of retirement income up to $1,200 which an individual receives is to be reduced for purposes of computing the credit, by any social security, railroad retirement, military retirement pension, or other retirement pension which is excluded from gross income. Military disability pensions or workmen's compensation payments, however, do not serve to reduce retirement income.

Of the exceptions provided by section 37(e) of the Code, section 104(a) requires the most careful consideration. It provides that gross income does not include—

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

The history of section 104 of the 1954 Code discloses that it was not the purpose of Congress in enactment of laws which resulted in the provisions of section 22(b)(5) of the 1939 Code, the section from which section 104 of the 1954 Code is derived, to change the broad intent of the Act of August 12, 1935, which amended the World War Veterans' Act of 1924, 49 Stat. 607, 38 U. S. C. 454a, C. B. XIV–2, 538 (1935), but only to extend its provisions to cover services in the armed forces of Allied armies in World War I. The Act by its terms was broad enough to cover amounts received as compensation for injuries or sickness by either a veteran of the American Armed Forces or his survivor.

Section 104(a)(1) and section 104(a)(4) of the Code are phrased in similar language. There are striking similarities between the type of compensation for injuries or sickness paid by the United States to veterans and their survivors and workmen's compensation. Death benefits are commonly paid to a surviving widow under workmen's compensation laws. There appears to be nothing in the legislative history of the pertinent statutory provisions, or otherwise, to justify a difference in the tax treatment of these two types of compensation payments to survivors.

The payments made to the taxpayer representing amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the Armed Forces are, accordingly, considered to come within the scope of section 104(a)(4) of the Code, one of the exceptions of excluded income provided by section 37(e) of the Code for the application of section 37(d)(1) in determining the limitation on retirement income. Since such payments come within the exceptions of excluded income, they do not reduce the taxpayer's retirement income on which the retirement income credit is based.

Accordingly, it is held that retirement income, for the purpose of the credit provided by section 37 of the Internal Revenue Code of 1954, is not to be reduced by the amount of the death compensation paid to the widow of a veteran by the Veterans' Administration whose death in service or after discharge or retirement was due to service rendered during a war.

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SUBCHAPTER B.—COMPUTATION OF TAXABLE INCOME

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

SECTION 61.—GROSS INCOME DEFINED

(Also Section 170.) Rev. Rul. 56–126

Where a Congressman returns a portion of his salary as a Member of Congress to the United States Treasury, which salary is payable at the rate specified by law and must be so paid in full, according to a recent ruling of the Comptroller General, the full amount of such salary is includible in his gross income for the taxable year in which received and constitutes wages subject to the withholding of Federal income tax. However, in computing his taxable income, a deduction is allowable as a charitable contribution for the amount returned to the Treasury to the extent provided in section 170 of the Internal Revenue Code of 1954. Such contributions are deductible only to the extent that the total deduction under section 170(a) of the 1954 Code for the taxable year does not exceed 20 percent of the taxpayer's adjusted gross income without regard to any net operating loss carryback to the taxable year under section 172 of the 1954 Code.

Rev. Rul. 56–135

Amounts received by United States citizens living and working in the Republic of Panama as social security benefits under the provisions of the Republic of Panama Decree Law No. 14, dated August 27, 1954, which amended the original Law No. 134, dated April 27, 1943, do not constitute taxable income to them and are excludable from gross income for Federal income tax purposes. The benefit payments that may be made thereunder cover sickness, maternity, disability, old age and death. Such benefits are deemed to be basically similar to the sundry insurance benefit payments made to individuals under the United States social security system which are described and held to be nontaxable to the recipients in I. T. 3447, C. B. 1941–1, 191.

(Also Section 511.) Rev. Rul. 56–152

Where brokerage commissions are impressed with a trust and the brokers are obligated to deposit them in a special fund to be administered for public purposes, such commissions do not constitute income to the brokers. However, underwriting commissions retained by the underwriters constitute income to the recipients.

The handling of an insurance program for a municipal board of education and the receipt of brokerage commissions which are required to be deposited in a special fund for public purposes, does not affect the status of an insurance board held to be exempt from Federal income tax under section 501(c)(6) of the Internal Revenue Code of 1954.

Furthermore, such activity is not considered to be an unrelated trade or business within the meaning of section 513 of the 1954 Code.

Advice has been requested concerning the taxability of certain brokerage commissions received by individual insurance brokers, but which are deposited in a special fund used for public purposes.

A local insurance board, which has been held to be tax exempt under section 101(7) of the Internal Revenue Code of 1939 (corresponding to section 501(c)(6) of the 1954 Code), was requested by the municipal board of education to make a study of its insurance requirements and to recommend the nature and extent of the insurance coverage deemed necessary. The insurance board served gratuitously and appointed an advisory council consisting of insurance brokers with the authority to call upon the advice, counsel, and guidance of specialists in every form of insurance; to lend its efforts to advise the board of education in obtaining the broadest available insurance and surety protections; and to assist in the selection of an underwriting insurance company or companies. However, the actual selection of the insurance company and the authorized agent or agencies was left to the discretion of the board of education. The advisory council had no power to negotiate insurance contracts or receive commissions and donated their services without the expectation of a fee or reward.

The board of education adopted the recommendations of the insurance advisory council and placed insurance through underwriting agencies who are members of the insurance board. The underwriting agency retained as its income the underwriting commission which is normally earned on placing insurance, but the brokerage commission which is normally paid to the broker responsible for the insurance business was paid to a broker or brokers designated by the board of education. In every case, the brokers designated by the board of education were members of the insurance advisory council appointed by the insurance board and received the commissions in their capacity as members of the advisory council. Brokerage commissions received in this manner were allocated to a special fund established by the insurance board and deposited in a separate bank account. This special fund is used solely for public interests, that is, accident and fire prevention, auto driver education, life saving, and other means designed for the preservation of life and property. The fund is in no way used by the board of education for its regular activities but is used only for the special purposes enumerated and is administered by a committee consisting of members of the advisory council and of the insurance board.

The acceptance of an appointment to the advisory council by the insurance board obligates the insurance broker to apply any commissions received, by virtue of the business with the board of education, to the special fund. As a practical matter, the broker receiving the commissions will not have been directly responsible for the purchase of the insurance and would, therefore, have no personal claim to such commissions. The assignment of the commissions is merely a means of transferring the monies to the special fund.

The specific questions thus raised are in connection with whether (1) the brokerage commission may be excluded from the gross income of a broker who serves on the advisory council and who is designated by the board of education to receive the commissions payable on the insurance policies purchased by the board of education; (2) the insurance board may continue as a tax-exempt organization; and (3) the brokerage commissions received by the advisory council will constitute

income to the insurance board under the provisions of section 511 of the Internal Revenue Code of 1954.

Section 61 of the Code provides that all income from whatever source derived, including commissions, shall be included in gross income, except as otherwise provided. Section 511 of the Code provides, in part, that a tax shall be imposed on the unrelated business taxable income of a business league, chamber of commerce, real-estate board, or board of trade described in section 501(c)(6) of the Code.

However, in the case of *Commissioner* v. *Turney*, 82 Fed. (2d) 661, the court stated, in part, that tax officials are not required to treat as income money received by a taxpayer when, under well-settled law, his receipt of it has the effect of obligating him unconditionally to pay that money to another.

Also, in the case of *The Seven-Up Co.* v. *Commissioner*, 14 T. C. 965, acquiescence C. B. 1950–2, 4, it was held that when a taxpayer receives funds that are burdened with an obligation to be expended for a specific purpose and the funds are earmarked for such purpose, the funds so held do not result in gain or income to the taxpayer.

Since, in the instant case, the brokerage commissions are impressed with a trust and the brokers are obligated to deposit them in the special fund to be administered for public purposes by the insurance board, it is held that they do not constitute income to the brokers and should be excluded from their gross income. However, the underwriting commissions received by the underwriting agency constitute income to the recipients thereof. It is further held that the handling of the insurance program for the board of education and the receipt of the brokerage commissions which are to be placed in a special fund and expended for public purposes will not affect the exempt status of the insurance board under section 501(c)(6) of the Code. Furthermore, such activity is not considered an unrelated trade or business, since all the work is performed for the insurance board without compensation. Therefore, the brokerage commissions allocated to the special fund do not constitute unrelated business taxable income and the insurance board is not subject to tax with respect to such commissions.

Rev. Rul. 56–221

A mother and her two children each owned in fee simple an undivided one-third interest in income producing real property. The children, by deed, conveyed their right, title and interest in the property to her for her life with the remainder reserved to themselves. *Held*, the entire income derived from the property after conveyance of the life estate is includible for Federal income tax purposes in the gross income of the mother.

Rev. Rul. 56–225

Where, in the case of a cooperative housing corporation, as defined in section 216(b)(1) of the Internal Revenue Code of 1954, predetermined carrying charges are collected from the tenant-stockholders in excess of the actual carrying charges paid or incurred by the corporation, any refund of such charges occurring in the same year merely results in a contra-adjustment and only the net amount of the carrying charges would be taken into the accounts of the corporation for

Federal income tax purposes. However, where the excess of predetermined charges at the end of any year is not used to reduce carrying charges until a subsequent year or years, such excess constitutes income to the corporation subject to Federal income taxes in the year in which received.

Windows, doors, etc., placed on taxpayers' residences in consideration of use for demonstration purposes. See Rev. Rul. 56–181, page 96.

PART II.—ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

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

Rev. Rul. 56–82

For the purpose of arriving at the exclusion ratio used in computing amounts of annuities which may be excluded from gross income, annual amounts contributed by a state or political subdivision thereof to employees' tax-exempt pension funds prior to January 1, 1939, are added to contributions of employees in computing the consideration paid for the annuity contracts, to the extent that the amounts so contributed represent compensation for personal services rendered in the exercise of an essential governmental function, as distinguished from a proprietary function, and were not contributed directly or indirectly by the United States or an agency or instrumentality thereof.

Advice has been requested whether annual amounts contributed by a state or political subdivision thereof to employees' tax-exempt pension funds prior to January 1, 1939, may be added to contributions of employees, under section 72(f)(2) of the Internal Revenue Code of 1954, in computing the consideration paid for contracts for the purpose of arriving at the exclusion ratio, under section 72(b) of the 1954 Code, used in computing the portion of an annuity which is to be excluded from gross income.

In addition to the contributions required of employee-participants in the retirement system of the instant state, certain annual contributions are also required of the state or political subdivision participating in the plan. The plan has been held to meet the requirements of section 165(a) of the 1939 Code (section 401(a) of the 1954 Code).

Under the income tax laws in effect for the years 1913 through 1938, compensation of all officers and employees of a state, or a political subdivision thereof, for personal services rendered in the exercise of an essential governmental function, as distinguished from a proprietary function, was not includible in gross income unless paid directly or indirectly by the United States or an agency or instrumentality thereof. Public Salary Tax Act of 1939, C. B. 1939–1 (Part I) 428, as amended; T. D. 5214, C. B. 1943, 1188.

Section 402 of the 1954 Code provides that amounts distributed by an employees' trust, described in section 401(a) of the Code, which is exempt from tax under section 501(a) of the Code, shall be taxable in the year in which distributed, in accordance with section 72 of the Code, except that section 72(e)(3) shall not apply.

Section 72 of the Code provides for the taxation of amounts received as annuities under a contract whereby amounts received which are considered to be a return of the investment in the contract are excluded from gross income. Subsection (d) of section 72 provides that where part of the consideration paid for the contract is contributed by the employer and the aggregate amount receivable by the employee during the three-year period beginning with the date of the first payment is equal to or greater than the consideration for the contract contributed by the employee, then all amounts received shall be excluded from gross income until there has been excluded an amount equal to the consideration for the contract contributed by the employee; thereafter, all amounts so received shall be included in gross income. Where that portion of the cost of the contract which is contributed by the employee is not so recoverable within the first three years, commencing with the first date of payment, subsection (b) of section 72 provides an exclusion ratio whereby there is excluded from gross income an amount which bears the same ratio to the amount received as the employee's investment in the contract bears to the expected return under the contract.

Subsection (f) of section 72 of the Code provides that in the computation of the consideration paid for the contract the amount contributed by the employee shall include amounts contributed by the employer to the extent that (1) such amounts were includible in the gross income of the employee 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. See T. D. 6118, C. B. 1955–1, 698, at p. 702.

In view of the foregoing, it is held that amounts contributed prior to January 1, 1939, by a state, or a political subdivision thereof, to employees' tax-exempt pension funds may be added to the amounts contributed by the employees, in computing the consideration paid for annuity contracts, for the purpose of arriving at the exclusion ratio used in computing the portions of annuity payments which may be excluded from gross income, to the extent that the amounts so contributed represent compensation for personal services rendered in the exercise of an essential governmental function, as distinguished from a proprietary function, and were not contributed directly or indirectly by the United States or an agency or instrumentality thereof.

(Also Sections 402, 403.)
(Also Part II, Sections 22(b), 116, 165; Regulations 118, Sections 39.22(b) (2)–5, 39.116–1, 39.165–6.)

Rev. Rul. 56–123

In the determination of the investment in an annuity contract as of the annuity starting date, January 1, 1954, pension and annuity payments received by resident citizen-taxpayers before January 1, 1951, will be regarded as excludable from gross income under prior income tax laws to the extent that such payments were, in accordance with the principles announced in the case of *Charles A. Crispin et al.* v. *United States*, 200 Fed. (2d) 99, treated as excludable from gross income as consideration paid by the recipient because of the earned income exemption provided under section 116(a) of the 1939 Code.

However, such payments will not be so regarded if, in accordance with the position of the Revenue Service at that time, the recipient did not actually treat them as excludable from gross income as consideration paid for the annuity contract.

The Internal Revenue Service desires to clarify its position with regard to the determination of a taxpayer's investment in an annuity contract as of the annuity starting date, January 1, 1954, in cases where a United States citizen has rendered service for a domestic corporation for a number of years as a bona fide resident of a foreign country and, upon retirement in accordance with his employer's pension or annuity plan, resumes residence in the United States.

In general, pension and annuity payments received by resident citizen-taxpayers before January 1, 1951, will be regarded as "excludable from gross income under * * * prior income tax laws" for purposes of section 72(c)(1)(B) of the Internal Revenue Code of 1954, to the extent that such payments were, in accordance with the principles announced in the case of *Charles A. Crispin et al.* v. *United States*, 200 Fed. (2d) 99, treated as excludable therefrom as consideration paid by the recipient because of the earned income exemption provided under section 116(a) of the 1939 Code. However, in applying section 72(c)(1)(B) such payments will not be regarded as "excludable from gross income under * * * prior income tax laws" if, in accordance with the position of the Revenue Service at that time, the recipient did not actually treat them as excludable therefrom. See I. T. 3472, C. B. 1941–1, 252. Compare *Judson Wood, et al.* v. *United States*, 104 Fed. Supp. 1020; and *Estate of James W. Flanagan, et al.* v. *Commissioner*, 18 T. C. 1241.

It is further held that for the purpose of determining the previously unrecovered premiums or other consideration paid for an annuity contract under section 72(e)(1)(B), or the previously unrecovered employee contributions to or under an exempt employees' trust or qualified annuity plan under sections 402(a)(2) and 403(a)(2)(A), the expressions "amounts * * * which were excludable from gross income under this subtitle or prior income tax laws," in section 72 (e)(1)(B); "amounts theretofore distributed * * * which were not includible in gross income," in section 402 (a) (2); and "amounts theretofore paid * * * which were not includible in gross income," in section 403(a)(2)(A) of the 1954 Code have the same general meaning and are to be similarly interpreted.

The following example will serve to illustrate the foregoing:

The *M* corporation, a domestic corporation, has had in effect for many years a noncontributory pension plan for all of its employees, including those in its service in foreign countries. The plan is funded and administered through a trust which has been held to be entitled to tax exemption under section 165(a) of the 1939 Code (section 501(a) of the 1954 Code) and corresponding provisions of prior internal revenue laws.

The corporation had contributed $70,000 to the pension plan on behalf of employee *A*, a United States citizen, who retired on December 31, 1945, after a lengthy period of service all of which was rendered as a bona fide resident of a foreign country. In January 1946, *A* resumed residence in the United States where he has been in receipt of monthly pension or annuity payments totalling $6,000 per annum under the *M* corporation pension plan. For each of the calendar years

1946 to 1951, inclusive, *A* paid United States income tax on the total of $6,000 received as annuity payments in each of such years.

Late in 1952, *A* filed amended income tax returns and claims for refund for the tax years 1949 to 1951, inclusive, contending that he should have been taxed, in those years, on only $2,100 (three percent of $70,000 contributed by his employer on account of his service rendered as a bona fide resident of a foreign country) on the basis of the decision in the Crispin case and the amendment of section 116(a) of the 1939 Code by section 321(a) and (c) of the Revenue Act of 1951, 65 Stat. 452. Section 322(b) of the 1939 Code barred claims for refund for years prior to 1949. The Commissioner of Internal Revenue allowed in full the claims for refund for these years.

For each of the taxable years 1952 and 1953, *A* properly included only $2,100 of his annuity in his gross income for Federal income tax purposes. See Revenue Ruling 56–125, page 627, of this Bulletin.

Thus, for the purpose of determining the investment in his annuity contract as of January 1, 1954, it is held that *A* will be required to treat $3,900 ($6,000 less $2,100) of the annuity payments received in each of the taxable years 1949 to 1953, inclusive, as an "amount * * * excludable from gross income under * * * prior income tax laws" within the meaning of that expression as used in section 72(c)(1)(B) of the 1954 Code.

It is also held that, for the same purpose, *A* will not be required to treat any part of the annuity payments received in the taxable years 1946 to 1948, inclusive, as an "amount * * * excludable from gross income under * * * prior income tax laws," within the meaning of section 72(c)(1)(B) of the 1954 Code, inasmuch as a resident United States citizen receiving a pension or annuity in those years for employment outside the United States was not permitted under the then position and rulings of the Service to exclude from his gross income, as a part of his consideration paid for his annuity, the amount of his employer's contributions toward the cost of such part of his annuity as was attributable to his foreign service. The same would be true for the years 1949 and 1950 if *A* had not obtained refunds for those years as assumed in this illustrative case.

PART III.—ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

SECTION 103.—INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS

(Also Section 4292.) Rev. Rul. 56–33

The Indiana Toll Road Commission was created as a body both corporate and politic under Chapter 281 of the Acts of the General Assembly of the State of Indiana of 1951, effective March 7, 1951. The Commission is authorized and empowered to construct, maintain, repair, police, and operate toll road projects (as defined in the Acts) at such locations as shall be approved by the Governor of Indiana and in accordance with such alignment and design standards as shall be approved by the State Highway Commission of Indiana. The Toll Road Commission is further authorized and empowered to acquire public or

private lands in the name of the State by purchase or condemnation; to issue toll road revenue bonds, payable solely from revenues, for the purpose of paying all or any part of the cost of any one or more toll road projects; and to fix and revise from time to time, and charge and collect, tolls from transit over each toll road project constructed by it and charges for the use of the facilities thereof. *Held*, the Indiana Toll Road Commission is a political subdivision of a State within the meaning of sections 103(a)(1) and 4292 of the Internal Revenue Code of 1954. Accordingly, the interest on bonds issued by the Commission is exempt from Federal income tax. See *Commissioner* v. *Estate of Alexander J. Shamberg*, 144 Fed. (2d) 998, Ct. D. 1648, C. B. 1945, 335, certiorari denied, 323 U. S. 792, and *Commissioner* v. *Estate of Caroline White*, 144 Fed. (2d) 1019, Ct. D. 1647, C. B. 1945, 65, certiorari denied, 323 U. S. 792. Also, amounts paid for the transportation of property to or from that Commission are exempt from the tax on the transportation of property. See Revenue Ruling 55–162, C. B. 1955–1, 541, relating to the exemption of amounts paid for the transportation of construction materials consigned to a state or political subdivision thereof, in care of a contractor, for incorporation into a state project.

Interest on special assessment assignable certificates issued by a municipality to a contractor in consideration for services rendered. See Rev. Rul. 56–159, page 609.

SECTION 104.—COMPENSATION FOR INJURIES OR SICKNESS

26 CFR 1.104: Statutory provisions: Compensation for injuries or sickness. T. D. 6169 [1]
(Also Sections 105, 106; 1.105–1, 1.106–1.)

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Regulations prescribed under sections 104, 105, and 106 of the Internal Revenue Code of 1954.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

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AUTHORITY: §§ 1.104 to 1.106–1, incl., issued under secs. 105, 7805, I. R. C. 1954; 69A Stat. 30, 917; 26 U. S. C. 105, 7805.

On March 24, 1955, notice of proposed rulemaking regarding the regulations under sections 104, 105, and 106 of the Internal Revenue Code of 1954, was published in the Federal Register (20 F. R. 1779). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the following regulations are hereby prescribed for taxable years beginning after December 31, 1953 and ending after August 16, 1954:

§ 1.104 STATUTORY PROVISIONS; COMPENSATION FOR INJURIES OR SICKNESS.

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)).

§ 1.104–1 COMPENSATION FOR INJURIES OR SICKNESS.—(a) *In general.*—Section 104(a) provides an exclusion from gross income with respect to certain amounts described below in paragraphs (b), (c), (d), and (e), which are received for personal injuries or sickness, except to the extent that such amounts are attributable to (but not in excess of) deductions allowed under section 213 (relating to medical, etc., expense) for any prior taxable year. See section 213 and the regulations thereunder.

(b) *Amounts received under workmen's compensation acts.*—Section 104(a)(1) excludes from gross income amounts which are received by an employee under a workmen's compensation act (such as the Longshoremen's and Harbor Workers' Compensation Act, 33 U. S. C., c. 18, or under a statute in the nature of a workmen's compensation act which provides compensation to employees for personal injuries

or sickness incurred in the course of employment. Section 104(a)(1) also applies to compensation which is paid under a workmen's compensation act to the survivor or survivors of a deceased employee. However, section 104(a)(1) does not apply to a retirement pension or annuity to the extent that it is determined by reference to the employee's age or length of service, or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness. Section 104(a)(1) also does not apply to amounts which are received as compensation for a nonoccupational injury or sickness nor to amounts received as compensation for an occupational injury or sickness to the extent that they are in excess of the amount provided in the applicable workmen's compensation act or acts. See, however, §§ 1.105–1 through 1.105–5 for rules relating to exclusion of such amounts from gross income.

(c) *Damages received on account of personal injuries or sickness.*—Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort for tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

(d) *Accident or health insurance.*—Section 104(a)(3) excludes from gross income amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent that such amounts (1) are attributable to contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer). Similar treatment is also accorded to amounts received under accident or health plans and amounts received from sickness or disability funds. See section 105(e) and § 1.105–5. If, therefore, an individual purchases a policy of accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under section 104(a)(3). See, however, section 213 and the regulations thereunder, as to the inclusion in gross income of amounts attributable to deductions allowed under section 213 for any prior taxable year. Section 104(a)(3) also applies to amounts received by an employee for personal injuries or sickness from a fund which is maintained exclusively by employee contributions. Conversely, if an employer is either the sole contributor to such a fund, or is the sole purchaser of a policy of accident or health insurance for his employees (on either a group or individual basis), the exclusion provided under section 104(a)(3) does not apply to any amounts received by his employees through such fund or insurance. If the employer and his employees contribute to a fund or purchase insurance which pays accident or health benefits to employees, section 104(a)(3) does not apply to amounts received thereunder by employees to the extent that such amounts are attributable to the employer's contributions. See § 1.105–1 for rules relating to the determination of the amount attributable to employer contributions. Although amounts paid by or on behalf of an employer to an employee for personal injuries or sickness are not excludable from the employee's gross income under section 104(a)(3), they may be excludable therefrom under section 105. See §§ 1.105–1 through 1.105–5, inclusive.

(e) *Amounts received as pensions, etc., for certain personal injuries or sickness.*—Section 104(a)(4) excludes from gross income amounts which are 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. Section 104(a)(4) is applicable to a pension, annuity, or similar allowance received by the beneficiaries of an individual by reason of the death of such individual due to a personal injury or sickness resulting from service in the armed forces of any country, or the Coast and Geodetic Survey, or the Public Health Service. For purposes of this section, that part of the disability retirement pay computed on the basis of years of active service which is in excess of the disability retirement pay that would be received if such disability pay were computed on the basis of percentage of disability shall not be deemed to be 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 (see section 402(h) of the Career Compensation Act of 1949, 37 U. S. C. 272(h)).

§ 1.105 STATUTORY PROVISIONS; AMOUNTS RECEIVED UNDER ACCIDENT AND HEALTH PLANS.

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) ACCIDENTS 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 (a) or (d) shall not be considered as compensation (by insurance or otherwise) for expenses paid for medical care.

§ 1.105–1 AMOUNTS ATTRIBUTABLE TO EMPLOYER CONTRIBUTIONS.—(a) *In general.*—Under section 105(a), amounts received by an employee through accident or health insurance for personal injuries or sickness must be included in his gross income to the extent that such amounts (1) are attributable to contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer, unless such amounts are excluded therefrom under section 105 (b), (c), or (d). For purposes of this section, the term "amounts received by an employee through an accident or health plan" refers to any amounts received through accident or health insurance, and also to any amounts which, under section 105(e), are treated as being so received. See § 1.105–5. In determining the extent to which amounts received for personal injuries or sickness by an employee through an accident or health plan are subject to the provisions of section 105(a), rather than section 104(a)(3), the rules of paragraphs (b), (c), (d), and (e) of this section shall apply.

(b) *Noncontributory plans.*—All amounts received by employees through an accident or health plan which is financed solely by their employer, either by payment of premiums on an accident or health insurance policy (whether on a group or individual basis), by contributions to a fund which pays accident or health benefits, or by direct payment of the benefits under the plan, are subject to the provisions of section 105(a), except to the etxent that they are excludable under section 105 (b), (c), or (d). This rule may be illustrated by the following examples:

Example (1). Employer A maintains a plan for his employees which provides that he will continue to pay regular wages to employees who are absent from work due to sickness or personal injuries. Employees make no contributions to the plan and all benefits are paid by the employer. Amounts received by employees under the plan are subject to section 105(a), and must be included in gross income unless excluded therefrom under section 105 (b), (c), or (d).

Example (2). Pursuant to a State nonoccupational disability benefits law, employer B maintains an accident and health plan for his employees. Although under the State law B is authorized to withhold from his employees' wages a specified amount for employee contributions to the State fund, in actual practice B does not so withhold and makes all contributions out of his own funds. All amounts received by B's employees from the State fund are subject to section 105(a), and must be included in gross income unless excluded therefrom under section 105(b), (c), or (d).

(c) *Contributory plans.*—(1) In the case of amounts received by an employee through an accident or health plan which is financed partially by his employer and partially by contributions of the employee, section 105(a) applies to the extent that such amounts are attributable to contributions of the employer which were not includible in the employee's gross income. The portion of such amounts which is attributable to such contributions of the employer shall be determined in accordance with paragraph (d) of this section in the case of an insured plan, or paragraph (e) of this section in the case of a noninsured plan. As used in this section, the phrase "contributions of the employer" means employer contributions which were not includible in the gross income of the employee. See section 106 for the exclusion from an employee's gross income of employer contributions to accident or health plans.

(2) A separate determination of the portion of the amounts received under the accident or health plan which is attributable to the contributions of the employer shall be made with respect to each class of employees in any case where the plan provides that some classes of covered employees contribute but others do not, or that the employer will make different contributions for different classes of employees, or that different classes of employees will make different contributions, and where in any such case both the contributions of the employer on account of each such class of employees and the contributions of such class of employees can be ascertained. For example, if employees contribute during the first year of employment but not thereafter, there will have to be a separate determination for first year employees, provided that the amount of the contributions of the employer on account of first-year employees and the contributions of such first-year employees can be ascertained for the required periods to apply the rules of paragraph (d) or (e) of this section. If in such a case the contributions of the employer to the plan on account of first-year employees are not distinguishable from his other contributions to the plan, then the determination shall be made for all employees under the plan, and such determination shall be used by all employees under the plan.

(3) If the plan provides accident or health benefits as well as other benefits for the employees, and if the respective contributions made by the employer and the employees to provide the accident or health benefits cannot be ascertained, the determination of the portion of the accident or health benefits received under such plan which is attributable to the contributions of the employer shall be made in accordance with the rules of paragraph (d) or (e) of this section on the basis of the contributions of the employer and of the employees to the entire plan.

(4) A determination of the portion attributable to the contributions of the employer, once made in accordance with the rules of this section, shall as to such portion be used for all purposes. For example, if an employee receives amounts under a wage continuation plan during the month of January and terminates his services during February, the portion of such amounts which is attributable to the contributions of the employer may be determined in order to provide the employee with such information at the time he is provided his Form W–2. The determination made for such purpose will also be used by the

employee to report his income for his taxable year in which such amounts are received, without regard to the experience under the plan for the rest of the year.

(d) *Insured plans.*—(1) *Individual policies.*—If an amount is received from an insurance company by an employee under an individual policy of accident or health insurance purchased by contributions of the employer and the employee, the portion of the amount received which is attributable to the employer's contributions shall be an amount which bears the same ratio to the amount received as the portion of the premiums paid by the employer for the current policy year bears to the total premiums paid by the employer and the employee for that year. This rule may be illustrated by the following example:

Example. Employer A maintains a plan whereby he pays two-thirds of the annual premium cost on individual policies of accident and health insurance for his employees. The remainder of each employee's premium is paid by a payroll deduction from the wages of the employee. The annual premium for employee X is $24, of which $16 is paid by the employer. Thus, 16/24 or two-thirds of all amounts received by X under such insurance policy are attributable to the contributions of the employer and are subject to section 105(a), and the remaining one-third of such amounts is excludable from X's gross income under section 104(a)(3).

(2) *Group policies.*—If the accident or health coverage is provided under or is a part of a group insurance policy purchased by contributions of the employer and of the employees, and the net premiums for such coverage for a period of at least three policy years are known at the beginning of the calendar year, the portion of any amount received by an employee which is attributable to the contributions of the employer for such coverage shall be an amount which bears the same ratio to the amount received, as the portion of the net premiums contributed by the employer for the last three policy years which are known at the beginning of the calendar year, bears to the total of the net premiums contributed by the employer and all employees for such policy years. If the net premiums for such coverage for a period of at least three policy years are not known at the beginning of the calendar year but are known for at least one policy year, such determination shall be made by using the net premiums for such coverage which are known at the beginning of the calendar year. If the net premiums for such coverage are not known at the beginning of the calendar year for even one policy year, such determination shall be made by using either (i) a reasonable estimate of the net premiums for the first policy year, or (ii) if the net premiums for a policy year are ascertained during the calendar year, by using such net premiums. These rules may be illustrated by the following example:

Example. An employer maintains a plan under which a portion of the cost of a group policy of accident and health insurance for his employees is paid through payroll deductions from wages of the employees. The remainder of the cost is borne by the employer. The policy year begins on November 1 and ends on October 31. The net premium for the policy year ended October

31, 1954, is not known on January 1, 1955, because certain retroactive premium adjustments, such as dividends and credits, are not determinable until after January 1. Therefore, for purposes of this computation the last three policy years are the policy years ended October 31, 1951, 1952, and 1953. The net premium for the policy year ended October 31, 1953, was $8,000, of which the employer contributed $3,000; the net premium for the policy year ended October 31, 1952, was $9,000, of which the employer contributed $3,500; and the net premium for the policy year ended October 31, 1951, was $7,000, of which the employer contributed $1,500. The portion of any amount received under the policy by an employee at any time during 1955 which is attributable to the contributions of the employer is to be determined by using the ratio of $8,000 ($3,000 plus $3,500 plus $1,500) to $24,000 ($8,000 plus $9,000 plus $7,000). Thus, $\frac{\$8,000}{\$24,000}$ or one third, of the amounts received by an employee at any time during 1955 is attributable to contributions of the employer.

(e) *Noninsured plans.*—If the accident or health benefits are a part of a noninsured plan to which the employer and the employees contribute, and such plan has been in effect for at least three years before the beginning of the calendar year, the portion of the amount received which is attributable to the employer's contributions shall be an amount which bears the same ratio to the amount received as the contributions of the employer for the period of three calendar years next preceding the year of receipt bear to the total contributions of the employer and all the employees for such period. If, at the beginning of the calendar year of receipt, such plan has not been in effect for three years but has been in effect for at least one year, such determination shall be based upon the contributions made during the 1-year or 2-year period during which the plan has been in effect. If such plan has not been in effect for one full year at the beginning of the calendar year of receipt, such determination may be based upon the portion of the year of receipt preceding the time when the determination is made, or such determination may be made periodically (such as monthly or quarterly) and used throughout the succeeding period. For example, if an employee terminates his services on April 15, 1955, and 1955 is the first year the plan has been in effect, such determination may be based upon the contributions of the employer and the employees during the period beginning with January 1 and ending with April 15, or during the month of March, or during the quarter consisting of January, February, and March.

§ 1.105–2 Amounts Expended for Medical Care.—Section 105(b) provides an exclusion from gross income with respect to the amounts referred to in section 105(a) (see § 1.105–1) which are paid, directly or indirectly, to the taxpayer to reimburse him for expenses incurred for the medical care (as defined in section 213(e)) of the taxpayer, his spouse, and his dependents (as defined in section 152). However, the exclusion does not apply to amounts which are attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year. See section 213 and the regulations thereunder. Section 105(b) applies only to

amounts which are paid specifically to reimburse the taxpayer for expenses incurred by him for the prescribed medical care. Thus, section 105 (b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care. For example, if under a wage continuation plan the taxpayer is entitled to regular wages during a period of absence from work due to sickness or injury, amounts received under such plan are not excludable from his gross income under section 105(b) even though the taxpayer may have incurred medical expenses during the period of illness. Such amounts may, however, be excludable from his gross income under section 105(d). See § 1.105–4. If the amounts are paid to the taxpayer solely to reimburse him for expenses which he incurred for the prescribed medical care, section 105(b) is applicable even though such amounts are paid without proof of the amount of the actual expenses incurred by the taxpayer, but section 105(b) is not applicable to the extent that such amounts exceed the amount of the actual expenses for such medical care. If the taxpayer incurs an obligation for medical care, payment to the obligee in discharge of such obligation shall constitute indirect payment to the taxpayer as reimbursement for medical care. Similarly, payment to or on behalf of the taxpayer's spouse or dependents shall constitute indirect payment to the taxpayer.

§ 1.105–3 PAYMENTS UNRELATED TO ABSENCE FROM WORK.—Section 105(c) provides an exclusion from gross income with respect to the amounts referred to in section 105(a) to the extent that such amounts (a) constitute payments for the permanent loss or permanent 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 (b) are computed with reference to the nature of the injury without regard to the period the employee is absent from work. Loss of use or disfigurement shall be considered permanent when it may reasonably be expected to continue for the life of the individual. For purposes of section 105(c), loss or loss of use of a member or function of the body includes the loss or loss of use of an appendage of the body, the loss of an eye, the loss of substantially all of the vision of an eye, and the loss of substantially all of the hearing in one or both ears. The term "disfigurement" shall be given a reasonable interpretation in the light of all the particular facts and circumstances. Section 105(c) does not apply if the amount of the benefits is determined by reference to the period the employee is absent from work. For example, if an employee is absent from work as a result of the loss of an arm, and under the accident and health plan established by his employer, he is to receive $125 a week so long as he is absent from work for a period not in excess of 52 weeks, section 105(c) is not applicable to such payments. See, however, section 105(d) and § 1.05–4. However, for purposes of section 105(c), it is immaterial whether an amount is paid in a lump sum or in installments. Section 105(c) does not apply to amounts which are treated as workmen's compensation under § 1.104–1(b), or to amounts paid by reason of the death of the employee (see section 101).

§ 1.105–4 WAGE CONTINUATION PLANS.—(a) *In general.*—(1) Subject to the limitations provided in this section, section 105(d) pro-

vides an exclusion from gross income with respect to amounts referred to in section 105(a) which are paid to an employee through a wage continuation plan and which 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.

(2)(i) Section 105(d) is applicable only if the wages or payments in lieu of wages are paid pursuant to a wage continuation plan. The term "wage continuation plan" means an accident or health plan, as defined in § 1.105-5, under which wages, or payments in lieu of wages, are paid to an employee for a period during which he is absent from work on account of a personal injury or sickness. Such term includes plans under which payments are continued as long as the employee is absent from work on account of personal injury or sickness. It includes plans under which there is a limitation on the period for which benefits will be paid, such as 13 or 26 weeks, and also plans under which benefits are continued until the employee either is able to return to work or reaches retirement age. Such term also includes a plan under which wages or payments in lieu of wages are paid to an employee who is absent from work on account of personal injury or sickness, even though the plan also provides that wages or payments in lieu of wages may be paid to an employee who is absent from work for reasons other than a personal injury or sickness.

(ii) Section 105(d) is applicable if, and only if, the employee is absent from work and such absence is due to a personal injury or sickness. Thus, if an employer has a plan for continuing the wages of employees when they are absent from work regardless of the cause of the absence from work, section 105(d) is applicable to any payments made under this plan to an employee whose absence from work is in fact due to a personal injury or sickness. On the other hand, although the terms of a plan provide that benefits are to be continued only as long as the employee is absent from work on account of a personal injury or sickness, section 105(d) does not apply to payments made to an employee for a period of absence from work where such absence is not in fact due to a personal injury or sickness.

(3)(i) Section 105(d) applies only to amounts attributable to periods during which the employee would be at work were it not for a personal injury or sickness. Thus, an employee is not absent from work if he is not expected to work because, for example, he has reached retirement age. If a plan provides that an employee, who is absent from work on account of a personal injury or sickness, will receive a disability pension as long as he is disabled, section 105(d) is applicable to any payments which such an employee receives under this plan before he reaches retirement age, but section 105(d) does not apply to the payments which such an employee receives after he reaches retirement age.

(ii) Similarly, an employee who incurs a personal injury or sickness during his paid vacation is not allowed to exclude under section 105(d) any of the vacation pay which he receives, since he is not absent from work on account of the personal injury or sickness. Likewise, a teacher who becomes sick during the summer or other vacation period when he is not expected to teach, is not entitled to any exclusion under section 105(d) for the summer or vacation period. However, if an employee who would otherwise be at work during a particular period is absent from work and his absence is in fact due to a personal injury

or sickness, a payment which he receives for such period under a wage continuation plan is subject to section 105(d).

(4) A period of absence from work shall commence the moment the employee first becomes absent from work and shall end the moment the employee first returns to work. However, the exclusion provided under section 105(d) is applicable only to payments attributable to a period of absence from work which is due to a personal injury or sickness, and to payments attributable to a period when the employee would have been at work but for such personal injury or sickness.

(5) For the purpose of section 105(d), whether an employee is absent from work depends upon all the circumstances. For example, an employee, who is a farm hand and who lives upon the premises of his employer, is absent from work when he is unable to work even though he remains on the premises of his employer. A member of the Armed Forces who on a particular day has no assigned duties but to stand ready for duty, is absent from work if he is unable to answer any duty call that may be made upon him. An employee is not absent from work when he performs any services for his employer at his usual place or places of employment, whether or not the services are the usual services performed by the employee. Furthermore, the employee is not absent from work when he performs substantial services for his employer, even though they are performed at a place other than his usual place of employment. Thus, if an employee returns to his usual place or places of employment and performs any services for his employer, he has returned to work, but if he merely holds occasional short conferences concerning his work with other employees or clients while hospitalized or at home recuperating, such conferences do not constitute a return to work.

(b) *Determination of amount attributable to period of absence.*— The amount which is paid to an employee as wages or payments in lieu of wages for a period of absence from work due to a personal injury or sickness shall be determined by reference to the plan under which the amount is paid, and to the contract, statute, or regulation which provides the terms of the employment. However, unless the plan, contract, statute, or regulation provides otherwise, it will be presumed that no wages or plan benefits are attributable to days (or portions of days) which are not normal working days for the particular employee. Also, section 105(d) does not apply to amounts earned prior to or subsequent to the period of absence from work, even though received during such period. These rules may be illustrated by the following examples:

Example (1). Employee A, who receives regular wages of $70 per week, normally works five days (Monday through Friday) during each week. A is absent from work on a Friday and the succeeding Monday (two working days) on account of a personal injury, but receives his regular wages with respect to such period of absence under his employer's accident and health plan. Unless the plan of A's employer, or the contract, statute, or regulation under which A is employed, provides otherwise, it will be presumed that A is not paid with respect to nonworking days (Saturday and Sunday). Therefore, the amount received by A with respect to his period of absence from work due to injury is $28, which is two days regular wages. If the plan, or the employment contract, statute, or regulation had provided that wages were

paid on a 7-day per week basis and that A must be available for call to work on Saturday and Sunday, A's daily wage would have been $10, and the amount attributable to the period of absence would have been $40 ($10 per day for four days).

Example (2). Employee B is a salesman who is paid on a commission basis. The employer purchases for B an accident and health insurance policy which provides that B shall receive $50 per week during any period (after a 7-day waiting period) that he is unable to work due to personal injuries or sickness. B incurs a personal injury and is incapacitated for two weeks. He receives $50 under the insurance policy with respect to the second week of absence. In addition, during the 2-week period of absence he receives a check for $40 from his employer as his commission on a sale which he made before becoming incapacitated. Section 105(d) applies to the $50 received through the insurance policy, but does not apply to the $40 commission which B earned prior to the period of absence from work.

(c) *Limitation in the case of absence from work due to sickness.*— (1) In the case of a period of absence from work on account of sickness, the exclusion provided by section 105(d) does not apply to amounts attributable to the first seven calendar days of each such period, unless the employee is hospitalized on account of sickness for at least one day during the period of absence from work. This 7-day rule applies to each period of absence from work because of sickness, regardless of the frequency of such absences or the closeness in time to any prior period of absence from work because of sickness. For example, employee A becomes absent from work because of sickness on Tuesday, October 4, and returns to work on the morning of Thursday, October 13. He suffers a relapse and again becomes absent from work on the afternoon of Thursday, October 13. A's return to work on the morning of Thursday, October 13, terminates the first period of absence from work because of sickness, and a new period of absence from work because of sickness begins on the afternoon of Thursday, October 13. The 7-day limitation does not apply if the absence from work is due to personal injuries. These rules may be illustrated by the following examples:

Example (1). Employee C normally works five days (Monday through Friday) during each week. On Saturday, October 1 (a nonworking day), C becomes sick and as a result, he does not return to work until Thursday, October 13. The period of absence from work due to sickness commences on Monday, October 3, and terminates when C returns to work on Thursday, October 13. If C is not hospitalized during such period of absence from work, section 105(d) does not apply to amounts which C receives under his employer's wage continuation plan attributable to the 7-day period commencing Monday, October 3, and ending Sunday, October 9, inclusive.

Example (2). Employee D incurs a personal injury which causes him to be absent from work two days. His regular wages are continued during this period in accordance with the wage continuation plan of his employer. Since D's absence from work was due to a personal injury, rather than sickness, the 7-day waiting period does not apply, and, subject to the other require-

ments of section 105(d), D is entitled to an exclusion with respect to the amounts received under the employer's plan attributable to the 2-day period of absence.

(2) The term "personal injury," as used in this section, means an externally caused sudden hurt or damage to the body brought about by an identifiable event. The term "sickness," as used in this section, means mental illnesses and all bodily infirmities and disorders other than "personal injuries." Diseases, whether resulting from the occupation or otherwise, are not considered personal injuries, but they are treated as a sickness.

(3) For the purpose of starting the 7-day waiting period, if the period of absence due to sickness commences after the start of a working day, the amount received with respect to the portion of such day that the employee is absent from work shall be considered the amount attributable to the first calendar day of the period of absence from work due to sickness. This rule may be illustrated by the following example:

Example. Employee E normally works from 9 a. m. until 5:30 p. m. on five days (Monday through Friday) during each week. From noon on Friday, September 3, until noon on Monday, September 13, E is absent from work on account of sickness but is not hospitalized at any time during this period. Section 105(d) does not apply to amount received by E under his employer's wage continuation plan which are attributable to the calendar period beginning September 3 and ending September 9, inclusive. However, if the other requirements of section 105(d) are met, E may exclude from gross income amounts attributable to the period beginning September 10 and ending at noon on September 13, inclusive.

(4) If the absence from work is due to sickness, the amount attributable to the first seven calendar days of such absence includes all amounts paid for such seven calendar days, regardless of the number of work days included in such seven calendar days. For example, if on one of such seven calendar days an employee would have worked two 8-hour shifts, the amount he is paid for the two shifts is considered to be an amount attributable to only one calendar day.

(5) An employee is considered to be hospitalized for one day only if he is admitted to and confined in a hospital as a bed patient for at least one hospital day. Entry into a hospital as an in-and-out patient does not constitute hospitalization for purposes of section 105(d). The same applies to mere entry into the out-patient ward or the emergency ward of a hospital.

(d) *Exclusion not applicable to the extent that amounts exceed a weekly rate of $100.*—(1) *In general.*—Amounts received under a wage continuation plan which are not excludable from gross income as being attributable to contributions of the employee (see § 1.105–1) must be included in gross income under section 105(d) to the extent that the weekly rate of such amounts exceeds $100. Thus, an employee, who receives $50 under his employer's wage continuation plan on account of his being absent from work for two days due to a personal injury, cannot exclude the entire $50 under section 105(d) if the weekly rate of such benefits exceeds $100. If an employee receives payments under a wage continuation plan for less than a full

pay period, the excludability of such payments shall be determined under subparagraph (2) of this paragraph. In all other cases, the weekly rate and excludability of such payments under a wage continuation plan shall be determined under subparagraph (3) of this paragraph. If, with respect to any pay period or portion thereof, the employee receives amounts under two or more wage continuation plans (whether such plans are maintained by or for the same employer or by different employers), the weekly rate and excludability of amounts received under each plan shall be determined under subparagraph (3) of this paragraph and the weekly rate for purposes of section 105(d) shall be the sum of all such weekly rates. This rule may be illustrated by the following example:

Example (1). An employee whose weekly salary is $120 is covered by two wage continuation plans maintained by his employer. Plan A is a contributory insured plan to which the employee contributes 60 percent of the premiums and which provides a weekly payment of $30. Plan B is a salary continuation plan completely financed by the employer. Since 60 percent of the cost of plan A is contributed by the employee, 60 percent of the weekly payment of $30 ($18) is excluded from gross income under section 104(a)(3). The remainder of each weekly payment ($12) is the weekly rate of plan A. Since the employer pays the entire cost of plan B, the weekly rate of this plan is the total amount paid per week. In the case of an employee whose weekly wages of $120 are continued under plan B, the weekly rate for the employee for purposes of section 105(d) is $132 ($120 from plan B, plus $12 from plan A).

Example (2). Assume, in example (1), that plan A provides a waiting period of four calendar days while plan B is effective immediately. For the first four days of absence the weekly rate for purposes of section 105(d) is $120, and for periods after the first four days the weekly rate for purposes of section 105(d) is $132.

(2) *Daily exclusion.*—If an employee receives payments under a wage continuation plan for less than a full pay period, the extent to which such benefits are excludable under section 105(d) shall be determined by computing the daily rate of the benefits which can be excluded under section 105(d). Such daily rate is determined by dividing the weekly rate at which wage continuation payments are excludable ($100) by the number of work days in a normal work week. This rule may be illustrated by the following example:

Example.—Employee E is covered by a wage continuation plan maintained by his employer providing that E's regular salary of $220 semimonthly will be continued in case he is absent from work on account of a personal injury or sickness. E is absent from work on account of a personal injury for thre days and under the plan he received $66 as wage continuation payments. The extent to which the $66 is excludable under section 105(d) shall be determined by dividing $100 by 5, the number of work days in a normal work week for E, resulting in a daily exclusion of $20 and a total exclusion of $60.

(3) *Determination of weekly rate at which amounts are paid under a wage continuation plan.*—(i) For purposes of this subpara-

graph the pay period of a particular wage continuation plan shall be determined by reference to such plan. If, in the usual operation of the plan, benefits ar paid for the same periods as regular wages, then the pay period of such benefits shall be the period for which a payment of wages is ordinarily made to the employee by the employer. If plan benefits are ordinarily paid for different periods than regular wages then the pay period of such benefits shall be the period for which payment of such benefits is ordinarily made.

(ii) The weekly rate shall be determined in accordance with the following rules:

(*a*) *Weekly pay period.*—If benefits are paid on the basis of a weekly pay period, the weekly rate at which such benefits are paid shall be the weekly amount of such benefits.

(*b*) *Biweekly pay period.*—If benefits are paid on the basis of a biweekly pay period, the weekly rate at which such benefits are paid shall be one-half of the biweekly rate.

(*c*) *Semimonthly pay period.*—If benefits are paid on the basis of a semimonthly pay period, the weekly rate at which such benefits are paid shall be the semimonthly rate multiplied by 24 and divided by 52.

(*d*) *Monthly pay period.*—If benefits are paid on the basis of a monthly pay period, the weekly rate at which such benefits are paid shall be the monthly rate multiplied by 12 and divided by 52.

(*e*) *Other pay periods.*—If benefits are paid on the basis of a period other than a period described in (*a*) through (*d*), the weekly rate at which such benefits are paid shall be determined by ascertaining the annual rate at which such benefits are paid and dividing such annual rate by 52.

(*f*) *Examples.*—The operation of these rules may be illustrated by the following examples:

Example (*1*). A's employer maintains a noncontributory plan which provides for the continuation of regular salary during periods of absence from work due to personal injury or sickness. A, an office employee, receives regular salary of $520 per month, and he is paid on the basis of a monthly pay period. Since benefits under the salary continuation plan are paid for the same periods as regular salary, the pay period of the plan is monthly. For purposes of section 105(d), the weekly rate at which benefits are paid to A under the plan is $120, determined as follows:

$520 (monthly rate) × 12 ---------- $6240 (annual rate)

$\frac{\$6240}{52}$ ---------- $120 (weekly rate)

Example (*2*). B, a factory employee of the same employer, is paid regular wages on the basis of a 10-day pay period. B's regular wages are $200 per pay period. If B is absent from work for 15 days, the weekly rate of the amount he receives under his employer's plan will be determined as follows:

$\frac{365 \times \$200}{10}$ ---------- $7300 (annual rate)

$\frac{\$7300}{52}$ ---------- $140.04 (weekly rate)

(iii) If the weekly rate for purposes of section 105(d) (as determined in subdivision (ii)) does not exceed $100, the amount received which is not attributable to the 7-day waiting period described in § 1.105–4(c) is fully excludable from gross income. If the weekly rate for purposes of section 105(d) (as determined in subdivision (ii)) exceeds $100, the amount received which is not attributable to the 7-day waiting period provided in § 1.105–4(c) is only partially excludable. The excludable portion of such amount shall bear the same ratio to such amount as $100 bears to the weekly rate for purposes of section 105(d). This rule may be illustrated by the following example:

Example. The weekly rate of benefits in the case of employee A in example (1) of subdivision (ii) was $120. If A does not receive amounts under any other plan, this is the weekly rate for purposes of section 105(d). Assume that A is absent from work on account of a personal injury for one full month and receives full pay of $520 for such period of absence. Since there is no waiting period requirement, the exclusion is $433.33, computed as follows:

$$\frac{\$100}{\$120} \times \$520 \text{ or } \$433.33.$$

§ 1.105–5 Accident and Health Plans.—Sections 104(a)(3) and and 105(b), (c), and (d) exclude from gross income certain amounts received through accident or health insurance. Section 105(e) provides that for the purposes of sections 104 and 105 amounts received through an accident or health plan for employees, and 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. In general, an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. A plan may cover one or more employees, and there may be different plans for different employees or classes of employees. An accident or health plan may be either insured or noninsured, and it is not necessary that the plan be in writing or that the employee's rights to benefits under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan (or a program, policy, or custom having the effect of a plan) providing for the payment of amounts to the employee in the event of personal injuries or sickness, and notice or knowledge of such plan was reasonably available to the employee. It is immaterial who makes payment of the benefits provided by the plan. For example, payment may be made by the employer, a welfare fund, a State sickness or disability benefits fund, an association of employers or employees, or by an insurance company.

§ 1.106 Statutory Provisions; Contributions by Employer to Accident and Health Plans.

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.

§ 1.106–1 CONTRIBUTIONS BY EMPLOYER TO ACCIDENT AND HEALTH PLANS.—The gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse, or his dependents, as defined in section 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in section 105(e)) which provides accident or health benefits directly or through insurance to one or more of his employees. However, if such insurance policy, trust, or fund provides other benefits in addition to accident or health benefits, section 106 applies only to the portion of the employer's contribution which is allocable to accident or health benefits. See § 1.104–1(d) and §§ 1.105–1 through 1.105–5, inclusive, for rules relating to exclusion from an employee's gross income of amounts received through accident or health insurance and through accident or health plans.

O. GORDON DELK,
Acting Commissioner of Internal Revenue.

Approved April 11, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Filed by the Division of the Federal Register April 13, 1956, 8:48 a. m.)

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26 CFR 1.104–1: Compensation for injuries or sickness. Rev. Rul. 56–83
(Also Section 105.)

Amounts received by an employee under a workmen's compensation act are excludable from the employee's gross income under section 104(a)(1). If the employee assigns or otherwise turns over such amounts to his employer and the employer continues regular salary payments to the absent employee, then the excess of the salary payments over the workmen's compensation payments represents the net expense to the employer, and must be included in the employee's gross income unless excluded therefrom as a wage continuation plan payment under section 105(d).

Advice has been requested with respect to the treatment of payments made to an employee for a period during which he was absent from work recovering from an injury received on the job. The employee received workmen's compensation each week, but turned the amount received over to the company by which he was employed inasmuch as he received his full wages from his employer.

Section 104 of the Internal Revenue Code of 1954 provides, in part, that amounts received under workmen's compensation acts, as compensation for personal injuries or sickness, shall be exempt from taxation.

Amounts paid to an employee, pursuant to the provisions of a wage continuation plan, for a period during which the employee is absent from work on account of personal injuries or sickness are (with certain limitations) excludable from the employee's gross income under section 105(d) of the Code.

Accordingly, it is held that workmen's compensation payments received by an employee are excludable from the employee's gross income under section 104(a)(1) of the Code, even though the employee assigns or otherwise turns over such payments to his employer. If the employer in turn makes payments as salary in excess of the workmen's compensation, the employee is required to report for Federal income tax purposes the excess amounts unless they are excludable as payments received under a wage continuation plan. The amount of the workmen's compensation payments turned over to the employer must be included in the employer's income and the salary payments made to the employee are deductible by the employer for tax purposes.

Payments to widow of a veteran who died from service-connected disabilities come within the scope of section 104. See Rev. Rul. 56-42, page 54.

SECTION 105—AMOUNTS RECEIVED UNDER ACCIDENT AND HEALTH PLANS

Amounts paid to an employee pursuant to a wage continuation plan. See Rev. Rul. 56-83, page 79.

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26 CFR 1.105-1: Amounts attributable to employer contributions.

Regulations under the Internal Revenue Code of 1954. See T. D. 6169, page 63.

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26 CFR 1.105-4: Wage continuation plans. T. D. 6177[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Section 1.105-4(d)(3)(ii)(*f*) of the Income Tax Regulations amended to correct a clerical error.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

In order to correct a clerical error in the regulations issued under section 105 of the Internal Revenue Code of 1954, section 1.105-4 (d) (3) (ii) (*f*) of the Income Tax Regulations [T. D. 6169, page 63, this Bulletin] is amended by striking the amount of "$140.04" shown as the weekly rate in example (2), and inserting in lieu thereof the amount of "$140.38".

Because this Treasury Decision merely corrects a clerical error made in the regulations issued under section 105 of the Internal Revenue Code of 1954, it is found unnecessary to issue this Treasury Decision with notice and public procedure thereon under section 4(a) of the Administrative Procedure Act, approved June 11, 1946, or subject to the effective date limitation of section 4(c) of that Act.

[1] 21 F. R. 3678.

(This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U. S. C. 7805).)

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved: May 24, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Filed by the Division of the Federal Register May 29, 1956, 8: 55 a. m.)

SECTION 106.—CONTRIBUTIONS BY EMPLOYER TO ACCIDENT AND HEALTH PLANS

26 CFR 1.106-1: Contributions by employer to accident and health plans.

Regulations under the Internal Revenue Code of 1954. See T. D. 6169, page 63.

SECTION 107.—RENTAL VALUE OF PARSONAGES

Exclusion from gross income of rental value of parsonages in the case of a minister of the gospel who reports base earnings for Old-age and Survivors Insurance. See Rev. Rul. 56-85, page 433.

SECTION 108.—INCOME FROM DISCHARGE OF INDEBTEDNESS

26 CFR 1.108(a)-1: Statutory provisions: Income from discharge of indebtedness. (Also Section 1017; 1.1017-1.) T. D. 6158[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Regulations prescribed under sections 108 and 1017 of the Internal Revenue Code of 1954.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

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[1] 21 F. R. 131.

Sec.
1.108(b)–1 Income from discharge of indebtedness of railroad corporations.
1.1017 Statutory provisions; basic rules of general application; discharge of indebtedness.
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AUTHORITY: §§ 1.108 to 1.108(b)–1, incl., 1.1017, 1.1017–1, 1–1017–2 issued under secs. 108, 1017, 7805, I. R. C. 1954; 68A Stat. 32, 301, 917; 26 U. S. C. 108, 1017, 7805.

On May 10, 1955, notice of proposed rulemaking regarding the regulations under sections 108 and 1017 of the Internal Revenue Code of 1954 (Public Law 591, 83d Cong.), approved August 16, 1954, was published in the Federal Register (20 F. R. 3152). After consideration of such relevant suggestions as were presented by interested persons regarding the proposals, the following regulations are hereby adopted:

§ 1.108(a) STATUTORY PROVISIONS; INCOME FROM DISCHARGE OF INDEBTEDNESS; SPECIAL RULE OF EXCLUSION.

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.

§ 1.108(a)–1 INCOME FROM DISCHARGE OF INDEBTEDNESS.—(a)(1) Section 108(a) provides a specific exclusion from gross income, at the taxpayer's election, of the amount of income attributable to the discharge of indebtedness, in whole or in part, within the taxable year. In order to take advantage of the exclusion, the taxpayer must file a consent to applicable regulations relating to the adjustment of basis, in accordance with § 1.108(a)–2. This section applies to indebtedness incurred or assumed either (i) by a corporation, or (ii) by an individual in connection with property used in his trade or business; and it covers any such indebtedness for which the corporate or individual taxpayer is liable or subject to which the taxpayer holds property.

(2) For purposes of section 108(a) and this section, the determination as to whether an indebtedness is incurred or assumed by an individual in connection with property used in his trade or business depends upon the facts of each particular case. Where an indebtedness (whether secured or unsecured) is incurred or assumed by an individual and where the proceeds of such indebtedness are used to purchase, improve, or repair property used in the trade or business, section 108(a) shall apply to the discharge of such indebtedness.

However, an indebtedness of an individual will not be considered as incurred in connection with property used in his trade or business merely because it can be shown that the indebtedness was secured by property used in the trade or business.

(b)(1) If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized premium, the amount of the income attributable to such premium shall be excluded from gross income. For example: On January 1, 1955, the M Corporation (which files its return on a calendar year basis) had outstanding an issue of A bonds of the face value of $10,000, and as of that day there was $100 unamortized premium on this bond issue. On September 1, 1955, the M Corporation purchased these bonds for $9,000. The total amount to be excluded from gross income under this section is $1,100.

(2) If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized discount, the amount of the deduction attributable to such discount shall be disallowed as a deduction. For example: On January 1, 1955, the N Corporation (which files its return on a calendar year basis) had outstanding an issue of B bonds of the face value of $10,000, and as of that day there was $50 unamortized discount on this bond issue. On September 1, 1955, the N Corporation purchased these bonds for $9,000. The total amount to be excluded from gross income under this section is $950.

(c) Section 108(a) and this section are inapplicable in the case of any discharge occurring in any proceeding under section 77B of the Bankruptcy Act (48 Stat. 912, repealed June 22, 1938), under Chapter X or XI of such Act (11 U. S. C., c. 10, 11), or under Chapter XV of such Act (53 Stat. 1134, expired July 31, 1940) if the proceeding under such Chapter XV was initiated by a petition filed on or before July 31, 1940, and with respect to any discharge of indebtedness to which section 108(b) applies.

§ 1.108(a)–2 Making and Filing of Consent.—In order to take advantage of the exclusion from gross income provided by section 108(a), a taxpayer must file with his return for the taxable year a consent to have the basis of his property adjusted in accordance with the regulations prescribed under section 1017 which are in effect at the time of filing such return. See §§ 1.1017–1 and 1.1017–2. In special cases, however, where the taxpayer establishes to the satisfaction of the Commissioner reasonable cause for failure to file the necessary consent with his original return, he may file the consent with an amended return or claim for credit or refund; and in such cases, the consent shall be to the regulations which, at the time of filing the consent, are applicable to the taxable year for which such consent is filed. In all cases the consent shall be made by or on behalf of the taxpayer on Form 982, in duplicate, in accordance with these regulations and the instructions on the form or issued therewith.

§ 1.108(b) Statutory Provisions; Income From Discharge of Indebtedness; Railroad Corporations.

SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS. * * *

(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.

§ 1.108(b)-1 INCOME FROM DISCHARGE OF INDEBTEDNESS OF RAILROAD CORPORATIONS.—(a) Under section 108(b), the amount of any income attributable to the discharge, cancellation, or modification, in whole or in part, within the taxable year, of any indebtedness of a railroad corporation as a result of an order of a court in a receivership proceeding, or in a railroad reorganization proceeding under section 77 of the Bankuptcy Act (11 U. S. C. 205) is excluded from the gross income of the railroad corporation. The section is applicable only in a case where income accrues to a taxpayer from the discharge, modification, or cancellation of the corporate indebtedness (whether in whole or in part) pursuant to a court order.

(b) The railroad corporations to which this section and section 108(b) apply are those defined in section 77(m) of the Bankruptcy Act (11 U. S. C. 205(m)), namely, any common carrier by railroad engaged in the transportation of persons or property in interstate commerce, except a street, a suburban, or interurban electric railway which is not operated as a part of a general railroad system of transportation or which does not derive more than 50 percent of its operating revenues from the transportation of freight in standard steam railroad freight equipment.

(c) As used in section 108(b) and this section, the term "indebtedness" means an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount.

(d) If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized premium, the amount of the income attributable to such premium shall be excluded from gross income. If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized discount, the amount of the deduction attributable to such discount shall be disallowed as a deduction. See §1.108(a)-1(b) for examples illustrating the application of this principle.

(e) The provisions of section 108(b) and this section are applicable with respect to any discharge occurring in a taxable year beginning before January 1, 1956.

§ 1.1017 STATUTORY PROVISIONS; BASIS RULES OF GENERAL APPLICATION; DISCHARGE OF INDEBTEDNESS.

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 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.

§ 1.1017–1 ADJUSTED BASIS; DISCHARGE OF INDEBTEDNESS; GENERAL RULE.—(a) In addition to the adjustments provided in section 1016 and the regulations thereunder which are required to be made with respect to the cost or other basis of property, and except as otherwise provided in section 372(a), 373(b)(2), or 1018, a further adjustment shall be made in any case in which there shall have been an exclusion from gross income under section 108(a) on account of a discharge of indebtedness during the taxable year. Such further adjustment shall, except as otherwise provided in § 1.1017–2, be made in the following manner and order (but in the case of an individual, subparagraphs (1) to (4), inclusive, shall apply only to property used in any trade or business of such individual):

(1) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable), whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been discharged, the cost or other basis of such property shall be decreased by an amount equal to the amount excluded from gross income under section 108(a) and attributable to the discharge of the indebtedness so incurred with respect to such property;

(2) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the discharge of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property) the cost or other basis of such property shall be decreased by an amount equal to the amount excluded from gross income under section 108(a) and attributable to the discharge of the indebtedness secured by such lien;

(3) Any excess of the total amount excluded from gross income under section 108(a) over the sum of the adjustments made under subparagraphs (1) and (2) of this paragraph shall next be applied to reduce the cost or other basis of all the property of the debtor (other than inventory and notes and accounts receivable) as follows: The cost or other basis of each unit of property shall be decreased in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of adjusted bases (without reference to this section) of all the property of the debtor other than inventory and notes and accounts receivable;

(4) Any excess of the total amount excluded from gross income under section 108(a) over the sum of the adjustments made under subparagraphs (1), (2), and (3) of this paragraph shall

next be applied to reduce the cost or other basis of inventory and notes and accounts receivable, as follows: The cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable;

(5) In the case of an individual, any excess of the total amount excluded from gross income under section 108(a) over the sum of the adjustments made under subparagraphs (1), (2), (3), and (4) of this paragraph shall next be applied to reduce the cost or other basis of his property held for the production of income, as follows: The cost or other basis of each unit of such property shall be decreased in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of the adjusted bases (without reference to this section) of all of such property of the debtor; and

(6) In the case of an individual, any excess of the total amount excluded from gross income under section 108(a) over the sum of the adjustments made under subparagraphs (1), (2), (3), (4), and (5) of this paragraph shall next be applied to reduce the cost or other basis of his property other than property used in any trade or business and property held for the production of income, as follows: The cost or other basis of each unit of such property shall be decreased in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of the adjusted bases (without reference to this section) of all of such property of the debtor.

In the application of subparagraphs (1), (2), (3), (4), (5) and (6) of this paragraph, no decrease in the cost or other basis of any property shall exceed the amount of adjusted basis of such property without reference to this section.

(b) For the purposes of this section:

(1) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(2) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay;

(3) The phrase "amount excluded from gross income under section 108(a)" means the amount of income excluded under that section reduced by any deduction disallowed under that section for unamortized discount;

(4) Adjustments to basis shall be made:

(i) In the case of property owned on the first day of the taxable year, as of that day;

(ii) In the case of property acquired after the first day of the taxable year, as of the day so acquired—

regardless of the time such property was subsequently sold, exchanged, or otherwise disposed of by the taxpayer;

(5) Whenever a discharge of indebtedness is accomplished by a transfer of the taxpayer's property in kind, the difference between the amount of the obligation discharged and the fair market value of the property transferred is the amount which may be applied in reduction of basis;

(6) Regardless of the amount excluded by the taxpayer from his gross income under section 108(a) and so stated on Form 982, the maximum amount by which basis may be reduced in respect of the discharge of any indebtedness is the amount of income resulting from the discharge of such indebtedness; and

(7) Any reduction in basis which remains to be taken (by reason of an exclusion from gross income under section 108(a)) after the application of subparagraph (1) of paragraph (a) of this section shall be applied first against property of a character subject to the allowance for depreciation under section 167, property with respect to which a deduction for amortization is allowable under section 168 or 169, and property with respect to which a deduction for depletion is allowable under section 611 (but not including property specified in section 613), in the order in which such property is described in subparagraphs (2) and (3) of paragraph (a) of this section. This rule shall not be applicable to property with respect to which basis is reduced under subparagraphs (5) and (6) of paragraph (a) of this section. Any further adjustment in basis required to be made under section 108 (a) shall be applied against other property in the order prescribed in subparagraphs (2), (3), (4), (5), and (6) of paragraph (a) of this section.

(c) The application of paragraph (a) of this section may be illustrated by the following examples:

Example (1). On January 1, 1954, the N Corporation owned an office building, which it sold in March 1954. In June 1954 it purchased a factory building. In October 1954 the N Corporation bought in its outstanding bonds at less than their face value. Assuming that there is a proper exclusion from gross income under section 108(a), the basis of each building shall be adjusted under section 1017 for the taxable year 1954. (But see § 1.1017-2.)

Example (2) The M Corporation had outstanding an issue of A bonds which it had sold at a premium and an issue of B bonds which it had sold at a discount. In July 1954 the M Corporation purchased such outstanding bonds for less than face value. The amount of income attributable to the discharge of the A bonds is $1,000 and the amount of unamortized premium (as of the first day of the taxable year in which the discharge occurred) is $200. The amount of income attributable to the discharge of the B bonds is $1,000 and the amount of unamortized discount (as of the first day of the taxable year in which the discharge occurred) is $50. Each issue of bonds is regarded as a separate indebtedness and the M Corporation may elect under section 108(a) with respect to each issue or both issues. If the M Corporation elects under section 108(a) to have excluded from gross income the amount of

income attributable to the discharge of the issue of A bonds, the total reduction in basis of property of the M Corporation shall not exceed $1,200. If the M Corporation elects with respect to the B bonds, the total reduction in basis shall not exceed $950. If the M Corporation elects with respect to both bond issues, the total reduction in basis shall not exceed $2,150.

§ 1.1017–2 Adjusted Basis; Discharge of Indebtedness; Special Cases.—(a) Section 1.1017–1 prescribes the general rule to be followed in adjusting basis of property where there is a proper exclusion from gross income under section 108(a). The taxpayer may, however, have the basis of his property adjusted in a manner different from that set forth in § 1.1017–1 upon a proper showing to the satisfaction of the Commissioner. Such adjustment, however, shall be consistent with the principles of § 1.1017–1. Variations from such general rule may, for example, involve adjusting the basis of only part of the taxpayer's property or adjusting the basis of all the taxpayer's property, according to a fixed allocation.

(b) A request for variations from the general rule prescribed in § 1.1017–1 shall be filed by the taxpayer with his return for the taxable year in which the discharge of indebtedness occurred unless a consent is permitted (under § 1.108(a)–2) after the original return has been filed, in which case such request shall be filed with the amended return or claim for credit or refund, as the case may be. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121. If no agreement is reached between the taxpayer and the Commissioner as to variations from the general rule prescribed in § 1.1017–1, then the consent filed on Form 982 shall be deemed to be a consent to the application of such general rule and such general rule shall prevail in the determination of the basis of the taxpayer's property. If no agreement is reached between the taxpayer and the Commissioner as to variations from the general rule and the taxpayer specifically states that he does not consent to the application of the general rule, then section 108(a) and section 1017 shall not apply.

Russell C. Harrington,
Commissioner of Internal Revenue.

Approved January 3, 1956.

H. Chapman Rose,
Acting Secretary of the Treasury.

(Filed by the Division of the Federal Register January 6, 1956, 8:46 a. m.)

SECTION 116.—PARTIAL EXCLUSION OF DIVIDENDS RECEIVED BY INDIVIDUALS

26 CFR 1.116: Statutory provisions; partial exclusion of dividends received by individuals.

Regulations under the 1954 Code relating to the partial exclusion of dividends received by individuals. See T. D. 6161, page 7.

26 CFR 1.116–1: Partial exclusion of dividends.

Treatment of dividends received by an individual through a partnership of which he is a partner. See Rev. Rul. 56–233, page 51.

SECTION 117.—SCHOLARSHIPS AND FELLOWSHIP GRANTS

Rev. Rul. 56–101

Under the provisions of the United States Information and Educational Exchange Act of 1948, 22 U. S. C. 1446, otherwise known as the Exchange Visitors Program, Filipino nationals entered the United States for the purpose of undergoing advanced training and postgraduate studies at approved hospitals and other institutions in the United States. They served as trainees, interns, and resident doctors with a training hospital. Each individual entered into a separate contract with the hospital. They received stipends which they claim were solely for the purpose of enabling them to undergo training so as to be of greater service to their people and not for professional employment. *Held*, where the trainee performs services which are of material benefit to the trainer and receives substantially the same amount as is paid to a citizen performing similar services, the payments made constitute compensation for personal services performed. Such payments are not excludable as fellowship grants under section 117 of the Internal Revenue Code of 1954. See Rev. Rul. 55–554, C. B. 1955–2, 36.

PART IV.—STANDARD DEDUCTION FOR INDIVIDUALS

SECTION 141.—STANDARD DEDUCTION

Rev. Rul. 56–284

A taxpayer who has an adjusted gross income of $5,000 or more and who, for the reason that he is married to a nonresident alien, is required to file a separate return is entitled to a standard deduction of $500.

Advice has been requested whether, under the cirumstances described below, a taxpayer is entitled to claim a deduction of $1,000 or $500 for the year 1954.

During 1954 and a part of 1955, the taxpayer, a United States citizen, was employed in the Philippines, Japan, and Korea. In March 1954, he married a nonresident alien and, in May 1955, he and his wife returned to the United States. For the year 1954, the taxpayer had adjusted gross income of $20,000, and his wife had no gross income from sources within the United States for that year.

Section 6013(a)(1) of the Internal Revenue Code of 1954 provides that no joint return may be made if either the husband or wife at any time during the taxable year is a nonresident alien.

In the case of an individual and at his election section 141 of the Code provides a standard deduction, as follows:

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.

The taxpayer was required to file a separate return for the year 1954 because his wife was a nonresident alien during a part of that year. Thus, even though he is a married individual with an adjusted gross income of $5,000 or more, the exception provided by section 141 of the Code limits the standard deduction to which he is entitled to $500.

PART VI.—ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

SECTION 162.—TRADE OR BUSINESS EXPENSES

Rev. Rul. 56-102

Contributions made by an employer into an independently controlled trust fund, created solely for the purpose of furnishing supplemental unemployment benefits to certain of its employees qualifying under a supplemental unemployment benefit plan as part of a collective bargaining agreement, constitute ordinary and necessary business expenses and are deductible from gross income.

Advice has been requested whether contributions made to a trust fund, pursuant to a collective bargaining agreement, constitute deductible business expenses.

The corporation, in carrying on its activities throughout the United States, employs a substantial number of people. It employs the accrual method of accounting and files its returns on a calendar year basis.

In connection with a collective bargaining agreement, entered into between the corporation and the exclusive bargaining representatives for all of its employees in the contract unit, covering many phases of the employer-employee relationship, such as rates of pay, wages, hours of employment and other benefits accruing to employees, provision was made for furnishing supplemental unemployment benefits to its hourly-rated employees. The agreement, as far as is pertinent, provides for the payment of supplemental unemployment benefits to such hourly-rated employees, which would be effected by means of a supplemental unemployment benefit plan. Under the plan, a trust fund was established and is administered, independently, by a qualified trust company acting as trustee for the benfit of the eligible hourly-rated employees. The benefits under the plan are paid out of the moneys paid into the trust fund by the corporation, in accordance with the agreement. The moneys paid into the trust fund are held in cash, or invested, in whole or in part, in general obligations of the United States Government. Contributions to the trust fund are in amounts computed at a specified rate per hour for each hour for

which pay is received by all hourly-rated eligible employees during each pay period. The trust fund is limited to a specific maximum amount, as provided in the agreement.

The benefits payable under the plan, less taxes withheld, if any, are in varying amounts and for varying periods, depending upon certain specified factors as provided in the agreement, such as, (1) the length of employment after the effective date; (2) employees' seniority; (3) the size of the fund; and (4) the credits accruable to the individual under the plan, and are limited in duration to a specified maximum period. They are payable only to an employee who is on lay-off which is incurred in a reduction in force or temporary lay-off and who has received an unprotested state system unemployment benefit, or is ineligible to receive such benefit for certain specified reasons. Under the plan, provisions is made for situations in which such benefits do, or do not, reduce or cancel state unemployment benefits and such payments are limited to a specified maximum amount. Provision is also made with respect to those eligible beneficiaries who are deceased or incompetent.

Under the plan, the contributions to the trust fund are made irrevocably. Consequently, the corporation does not have any title or interest in or to any of the assets of the trust fund during the ordinary operation of the plan. Instead, the legal title to the contributions and the assets rests in the trustee who uses them solely in the interests of the employees. Upon a termination of the plan, the amounts in the trust fund will be used to pay benefits to employees already or subsequently laid-off.

The facts in the instant case disclose that (1) the corporation is subject to a legally binding and enforceable agreement to pay fixed and determinable annual amounts into the trust fund controlled by an independent trustee; (2) the principal purpose of such agreement is to bestow cash benefits, in the prescribed manner during a particular period to certain qualifying employees and thus would be directly connected with the carrying on of the corporation's business activities; (3) the corporation does not have any reversionary interest in the assets comprising the trust funds nor may any of the payments made by the corporation be diverted by it for any purpose; and (4) upon termination of the plan, the trust fund is to continue to be held by the trustee and paid out until exhausted in order to provide unemployment benefits and administration expenses, in accordance with the terms of the plan.

In view of the above, it is held that the contributions made by the corporation into the trust fund, pursuant to the agreement, constitute business expenses deductible from gross income under section 162(a) of the Internal Revenue Code of 1954, in the taxable year in which paid or incurred. Section 404 of the Code governing the deduction for contributions of an employer under a deferred compensation plan does not apply to deductions for contributions under a plan which is primarily an unemployment benefit plan. Section 39.23(p)-1 of Regulations 118, applicable to the Internal Revenue Code of 1954 by virtue of T. D. 6091, C. B. 1954-2, 47.

(Also Sections 163, 266.) Rev. Rul. 56-136
(Also Part II, Sections 23(a), 23(b), 24(a); Regulations 118, Section 39.23(a)-1, 39.23(b)-1, 39.24(a)-6.)

Commitment fees or standby charges incurred by a taxpayer pursuant to a bond sale agreement, under which funds for construction purposes are made available to it in stated amounts over a specified period and which vary with the period of time during which the funds are held available by the lender, are deductible from income as current business expenses when paid or accrued, depending upon the taxpayer's method of accounting, or may, at the election of the taxpayer, be capitalized as part of the construction cost.

Advice has been requested (1) whether commitment fees or standby charges paid by a taxpayer pursuant to a bond sale agreement, the proceeds of which are to be used for construction purposes, are deductible in the taxable year paid or accrued as interest or as a business expense; (2) whether such commitment fees or standby charges should be treated as bond discount or expense and amortized over the life of the bonds; or (3) whether such commitment fees or standby charges are in the nature of a carrying charge, deductible as a business expense or capitalized as part of construction cost.

The commitment fees or standby charges under discussion are amounts paid, usually at one percent or less per annum, on unissued balances of bonds under a bond sale agreement whereby the total amount of bonds to be issued is delivered to the purchaser in agreed amounts over a specified period. Delivery of the bonds to the purchaser and the "draw down" of funds are related to the cash requirement of the particular taxpayer, and the commitment fees or standby charges are paid or incurred for the purpose of having money made available when needed and preserving a firm price and interest rate for the total bond issue, without incurring the heavy interest expense which would result if the bonds were sold in advance of full need of the funds.

Section 163 of the Internal Revenue Code of 1954 provides for the deduction of all interest paid or accrued within the taxable year on indebtedness. In *Estate of Willard P. Deputy* v. *Pierre S. Du-Pont*, 308 U. S. 488, Ct. D. 1435, C. B. 1940-1, 118, the court defines "interest on indebtedness" as meaning "compensation for the use or forbearance of money."

Since commitment fees or standby charges are not paid upon an indebtedness of the taxpayer, they are not considered to be "compensation for the use of forbearance of money" and, accordingly, do not represent interest on indebtedness within the meaning of section 163 of the Code.

Further, since the fees or charges appear to be expenses applicable to the standby period prior to the issuance of the bonds, they are not considered as bond discount or expense amortizable over the life of the bonds.

In accordance with the foregoing, the commitment fees or standby charges described herein are held to be business expenses deductible under section 162 of the Code, when paid or accrued, depending on the taxpayer's method of accounting. Such fees or charges are considered carrying charges which may, at the election of the taxpayer, be capitalized as part of construction cost in accordance with the

provisions of section 39.24(a)-6(b) of Regulations 118, made applicable to the 1954 Code by virtue of Treasury Decision 6091, C. B. 1954-2, 47. Once an election is made, however, to capitalize commitment fees or standby charges incurred with respect to a particular project, charges of the same type incurred with respect to the particular project in subsequent years must also be capitalized for the entire period to which the election so to treat items of that type is applicable.

(Also Section 262.) Rev. Rul. 56-168

Clarification of the position of the Service with respect to the deductibility of expenses of taxpayers and members of their families in making business trips and attending business or professional conventions, especially where opportunities for personal vacationing are also involved.

The question frequently arises whether the expenses of taxpayers and members of their families in making business trips and attending business or professional conventions are deductible for income tax purposes, especially where opportunities exist for personal vacationing in connection with the trip or convention. The purpose of this Revenue Ruling is to set forth guides for taxpayers and field officers of the Internal Revenue Service in determining the allocation and deductibility of such expenses.

Section 162(a) of the Internal Revenue Code of 1954 provides for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses (including the amount expended for meals and lodging) while away from home in pursuit of a trade or business. Only those expenses which are ordinary and necessary in the conduct of the business and are directly attributable to it may be deducted. See sections 39.23(a)-1, 39.23(a)-2(a), and 39.23(a)-2(f) of Regulations 118, which are applicable by virtue of Treasury Decision 6091, C. B. 1954-2, 47. Section 262 of the 1954 Code provides, with exceptions not here material, that no deduction shall be allowed for personal, living or family expenses.

Where opportunities exist for personal vacationing in connection with business trips or the attendance of business or professional conventions, and especially where the taxpayer is accompanied by one or more members of his family, it is apparent that examining officers of the Service have a duty to give especially careful scrutiny to deductions taken in returns for the expense involved in order to assure against abuse of the deduction permitted by section 162(a) of the Code. In those cases where a business purpose is served, it is also necessary to determine what portion of the total expense is deductible as an ordinary and necessary business expense and what portion represents nondeductible personal or living expenses.

In those cases where a taxpayer makes a business trip such as attending a convention or other business meeting and, as an incident of such trip, engages in some personal activity such as sightseeing, social visiting or entertaining, or other recreation, that part of the total expense of the trip which is directly attributable to the taxpayer's business will be treated as deductible notwithstanding the incidental personal activity. That part of the total expense which is properly

allocable to such incidental personal activities will be treated as nondeductible personal or living expenses. Where the purposes of a trip are primarily personal, the entire expense involved will be treated as nondeductible personal or living expenses notwithstanding that the taxpayer engages or participates in some incidental activity related to his business.

Where a taxpayer's wife accompanies him on a business trip, those expenses attributable to her travel are not deductible unless it can be adequately shown that the wife's presence on the trip has a bona fide business purpose. See Rev. Rul. 55–57, C. B. 1955–1, 315. The wife's performance of some incidental service does not cause her expenses to qualify as deductible business expenses. The same rules are applicable with respect to any other members of the taxpayer's family who accompany him on such a trip.

The application of the foregoing guides may be illustrated by the following examples:

(1) A taxpayer makes a business trip for the purpose of attending a convention held in a coastal city. During the period of the convention, he also engages in local sightseeing, entertaining, and visiting unrelated to his business. He also arranges to take a post-convention cruise made available to individuals attending the convention, the purpose of which is primarily recreational although some incidental sessions are scheduled for lectures, discussions, or exhibitions related to the business interests of the group holding the convention. The expenses paid for the local sightseeing, entertaining, and visiting and the entire cost of the post-convention cruise are deemed to represent nondeductible personal expenses.

(2) A taxpayer's wife accompanies him on a business trip, which may include his attendance of a business or professional convention. She occasionally types notes or performs some similar service and accompanies him to luncheons and dinners. The performance of such services does not establish that her presence is necessary to the conduct of the taxpayer's business.

(3) Under the circumstances involved in example (2) above, the cost of transportation and lodging exceeds the cost for single fares and accommodations but is less than twice the single rate. The amount deductible as an ordinary and necessary business expense on account of the transportation and lodging is the amount directly related to the business purpose of the trip, that is, the cost at the single rate for similar accommodations. The amount by which the total expense is increased because of the wife's presence and the entire cost of the wife's meals are not deductible.

(Also Part II, Section 23(a); Regulations 118, Section 39.23(a)–1.) Rev. Rul. 56–180

Payments made in settlement of a suit alleging violation of the Defense Production Act of 1950, as amended, which are not certified for disallowance to the Internal Revenue Service by the Economic Stabilization Agency or its authorized components, are to be taken into account and allowed for Federal income tax purposes.
I. T. 4105, C. B. 1952–2, 93, amplified.

Advice has been requested whether payments made in settlement of a suit alleging violation of the Defense Production Act of 1950, 64

Stat. 798, 50 U. S. C. 2061, as amended, are deductible from gross income where the amounts determined are not certified for disallowance to the Internal Revenue Service by the Economic Stabilization Agency or its authorized components.

A taxpayer sold scrap metal for prices in excess of the established ceiling price. Suit was instituted against him in 1951 alleging overcharges of 200x dollars. Treble damages were demanded. The suit was settled in 1954 for 100x dollars. The Economic Stabilization Agency, in conformity with its General Disallowance Order 1, 17 F. R. 9934, did not certify the disallowance of any of that payment and, accordingly, the taxpayer took a deduction for it on his 1954 Federal income tax return. The specific question presented is whether such payment is deductible, notwithstanding that it was made in settlement of a suit alleging violation of the Defense Production Act of 1950, as amended.

Subsections (b) and (c) of section 409 of such Act established penalties for violation of the Act and provided for recovery of overcharges by the buyer or the United States. Section 409(d) of the Act provided that the President shall prescribe the extent to which any payment, made by virtue of subsections (b) or (c) of the Act, shall be disregarded by the Executive Department and other governmental agencies in determining the costs or expenses of such other person for the purpose of any other law or regulation.

Section 401(a) of Executive Order 10161, 15 F. R. 6105, created the Economic Stabilization Agency and provided that the functions conferred upon the President by Title IV (which includes section 409) of the Defense Production Act of 1950 were to be delegated to the Administrator of the Agency. General Order 15, 17 F. R. 2994, of the Economic Stabilization Agency set forth the policy and procedure with respect to disallowances. Section 2(b) of the Order provided:

> In the case of payments by any person by way of fine for violation of the act, or by way of compromise or satisfaction of any liability, right of action, suit or judgment for violation of a price regulation or order under the act, the Director shall further determine the amount of such payment to be disallowed and disregarded and the purpose or purposes for which it shall be disallowed listed in section 4(a).

Section 6 of the Order provided:

> The Director of Price Stabilization, the Wage Stabilization Board, the Office of Salary Stabilization, and the Railroad and Airline Wage Board shall certify and forward their final determination in each case to the appropriate governmental agency or agencies. Any such determination shall be conclusive on all Executive Departments and agencies of the Government, and they shall disregard and disallow the amounts thus certified. * * *

General Disallowance Order 1 amended the policy to be followed in certifying disallowances. Section 2(b) of the Order provided, in part:

> Any payment made to the United States or to any buyer in compromise or satisfaction of any liability or of any right of action, suit, or judgment, authorized pursuant to section 409(c) of the act, for selling any material or service in violation of a regulation or order providing a ceiling or ceilings, shall be wholly disregarded: *Provided, however,* That the amount so paid to the United States or to any buyer shall not be disregarded for any purpose or to any extent if the total of the amount so paid (exclusive of attorney's fees, court costs, or interest, if any) does not exceed the total amount of the overcharge or overcharges upon which such liability, right of action, suit, or judgment was based. * * *

Section 3 of the General Disallowance Order, *supra*, provides that—

> * * * The Director of Enforcement of the Office of Price Stabilization or such person or persons as may be designated by him are hereby authorized to and, pursuant to procedures to be promulgated by the Director of Enforcement, shall forward to the Commissioner of Internal Revenue and to all other appropriate governmental agencies, a statement indicating any payment of the kind above described which, pursuant to the foregoing provisions of this order, should be disregarded by the executive departments and other governmental agencies for the purposes above indicated.

The pertinent language of section 409(c) of the Defense Production Act of 1950 is substantially similar to the corresponding provisions of the Emergency Price Control Act of 1942. The Service ruled in I. T. 3627, C. B. 1943, 111, and I. T. 3630, C. B. 1943, 113, that payments made to the United States under that Act were not deductible. These rulings were challenged in numerous cases and, in order to avoid extensive litigation on the same issue, Congress enacted section 409(d) as an amendment to the Defense Production Act of 1950. It was intended that the decision of the President was to be final and binding on all other agencies in all cases and section 401 of the Act directed that "all agencies dealing with the subject matter of this title * * *, within the limits of their authority and jurisdiction, shall cooperate in the carrying out of these purposes."

I. T. 4105, C. B. 1952–2, 93, holds that payments made in violation of the Defense Production Act of 1950, as amended, payments made by way of fine for violation of such Act, and payments made to the United States, or to any buyer of any material or service, in compromise or satisfaction of any liability arising from a violation, will be disregarded and disallowed for Federal income tax purposes, in the amounts determined and certified to the Internal Revenue Service by the Economic Stabilization Agency or its authorized components. It follows as a corollary that amounts not certified for disallowance shall be allowed for tax purposes.

Accordingly, payments made to the United States, or any buyer of material or service, by way of fine for violation of the Defense Production Act of 1950, as amended, or in compromise or reimbursement for alleged violation of such Act, which payments are not certified for disallowance to the Internal Revenue Service by the Economic Stabilization Agency, or its authorized components, are to be taken into account and allowed for Federal income tax purposes.

(Also Section 61.) Rev. Rul. 56–181

A corporation which manufactures louvered windows, jalousies, awnings, etc., is opening new sales territories. As part of an advertising campaign, certain of its products will be installed in a number of private homes, under an agreement with the individual home owner, by replacing the products already forming a part of the home. In consideration thereof, the home owner will permit the corporation to take photographs and publish them, and also to use the premises for demonstration of the installed products. The title to such products will be vested in the home owner. Any damages to the home by the workmen, contractors, or prospective customers of the corporation will be borne by the latter. *Held*, expeditures incurred as a result of

the installation and demonstration of certain products in private homes by a corporation, the manufacturer of such products, as a part of an advertising campaign to increase sales, are so directly related to the carrying-on of the corporation's business as to constitute a deductible business expense under the provisions of section 162(a) of the Internal Revenue Code of 1954. Any payments for damages done to the home resulting from the demonstration likewise would be deductible as an additional advertising expense. The home owner, in acquiring the installed products of the corporation as compensation for the use of the premises, derives taxable income measured by the excess of the fair market value of such products over the fair market value of the replaced products prior to removal.

Automobile expenses incurred by an employee in commuting to and from his work and transporting the tools which he uses in such work. See Rev. Rul. 56–25, page 152.

SECTION 163.—INTEREST

"Commitment fees" or "standby charges" incurred in connection with the provisions of a bond sale agreement. See Rev. Rul. 56–136, page 92.

SECTION 164.—TAXES

Rev. Rul. 56–124

The amount of Maryland State income tax withheld from an individual (cash method) taxpayer's salary or wages and/or the amount thereof paid by such taxpayer as estimated tax, pursuant to the pay-as-you-go plan of income tax collection adopted by that State in 1955, is deductible for Federal income tax purposes in the taxable year withheld and/or paid, providing the taxpayer itemizes his deductions.

Advice has been requested relative to the deductibility, for Federal income tax purposes, of the income tax withheld from an individual (cash method) taxpayer's salary or wages, and/or of the estimated income taxes paid by him to the State of Maryland after July 1, 1955, pursuant to legislation enacted by the general assembly of Maryland in 1955.

In accordance with the provisions of subsections (a) and (j) of section 308 of Article 81 of the Annotated Code of Maryland, 1955 Cumulative Supplement, as enacted by Section 5, Chapter 281 of the laws enacted by the General Assembly of the State of Maryland, in 1955, which became effective June 1, 1955, withholding of income tax on salaries and wages of both residents and nonresidents of Maryland began on July 1, 1955. Individuals receiving taxable income which is not subject to Maryland withholding were required to file declarations of estimated Maryland income tax on or before September 15, 1955. Under the law, not less than one-fourth of the estimated tax must be paid with the filing of the declaration. For the calendar year 1955, the first installment of the estimated tax was required to be paid with the declaration filed on or before September 15, 1955. The second

installment was due on or before January 15, 1956. The remaining one-half of the estimated tax due for 1955, is payable with the filing of the annual return on or before April 15, 1956. For 1956, and subsequent years, the estimated tax is due and payable, in installments of not less than one-fourth each, on or before April 15 (when the declaration is due) June 15, September 15, and January 15. For fiscal years beginning on or before June 1, 1955, a declaration of estimated tax was required to be filed by September 15, 1955; for fiscal years beginning after June 1, 1955, the declaration is required to be filed by the 15th day of the fourth month of such fiscal year.

Section 164(a) of the Internal Revenue Code of 1954 provides that in computing taxable income there shall be allowed as a deduction taxes paid or accrued within the taxable year, with certain exceptions not here material.

Under the provisions of section 461(a) of the Code, the amount of any allowable deduction or credit is to be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

In view of the foregoing, it is held that the amount of Maryland State income tax withheld from an individual (cash method) taxpayer's salary or wages, and/or the amount thereof paid by such taxpayer as estimated tax, is deductible from adjusted gross income in arriving at taxable income, for Federal income tax purposes, in the taxable year withheld and/or paid, providing the taxpayer does not elect the standard deduction provided in section 141 of the Code.

SECTION 167.—DEPRECIATION

26 CFR 1.167(a): Statutory provisions; Depreciation; general rule. T. D. 6182[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER A, PART I.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Regulations prescribed under section 167 of the Internal Revenue Code of 1954.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On November 11, 1955, a notice of proposed rulemaking with respect to section 167 of the Internal Revenue Code of 1954 (Public Law 591, 83d Congress, approved August 16, 1954) was published in the Federal Register (20 F. R. 8454). After consideration of all relevant matter presented by interested parties regarding the rules proposed, the regulations set forth below, which supersede paragraph (3) of Treasury Decision 6118 (19 F. R. 9896), approved December 30, 1954, are hereby adopted. (In addition, paragraphs (8) and (10) of Treasury Decision 6118 were superseded by Treasury Decision 6134

[1] 21 F. R. 3985.

(20 F. R. 4122), approved June 8, 1955; paragraphs (2) and (18) of Treasury Decision 6118 were superseded by Treasury Decision 6158 (21 F. R. 131), approved January 3, 1956; and paragraph (19) of Treasury Decision 6118 was superseded by Treasury Decision 6162 (21 F. R. 890), approved February 3, 1956.)

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1.167(c)–1	Limitations on methods of computing depreciation under section 167(b) (2), (3), and (4).
1.167(d)	Statutory provisions; depreciation; agreement as to useful life on which depreciation is based.
1.167(d)–1	Agreement as to useful life and rates of depreciation.
1.167(e)	Statutory provisions; depreciation; change in method.
1.167(e)–1	Change in method.
1.167(f)	Statutory provisions; depreciation; basis for depreciation.
1.167(f)–1	Basis for depreciation.
1.167(g)	Statutory provisions; depreciation; life tenants and beneficiaries of trusts and estates.
1.167(g)–1	Life tenants and beneficiaries of trusts and estates.
1.167(h)	Statutory provisions; depreciation; depreciation of improvements in the case of mines, etc.
1.167(h)–1	Depreciation of improvements in the case of mines, etc.

AUTHORITY: §§ 1.167(a) to 1.167(h)–1, inclusive, issued under secs. 167 and 7805, I. R. C. 1954; 68A Stat. 51,917; 26 U. S. C. 167, 7805.

§ 1.167(a) STATUTORY PROVISIONS; DEPRECIATION; GENERAL RULE.

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.

§ 1.167(a)–1 DEPRECIATION IN GENERAL.—(a) *Reasonable allowance.*—Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the

salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.*—For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.*—Salvage value is the amount (determined at the time of acquisition) which is estimated will be relizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantialy exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable

salvage value. See, however, § 1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

§ 1.167(a)-2 TANGIBLE PROPERTY.—The depreciation allowance in case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to inventories or stock in trade, or to land apart from the improvements or physical development added to it. The allowance does not apply to natural resources which are subject to the allowance for depletion provided in section 611. No deduction for depreciation shall be allowed on automobiles or other vehicles used solely for pleasure, on a building used by the taxpayer solely as his residence, or on furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be depreciated.

§ 1.167(a)-3 INTANGIBLES.—If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to good will. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder.

§ 1.167(a)-4 LEASED PROPERTY.—Capital expenditures made by a lessee for the erection of buildings or the construction of other permanent improvements on leased property are recoverable through allowances for depreciation or amortization. If the useful life of such improvements in the hands of the taxpayer is equal to or shorter than the remaining period of the lease, the allowances shall take the form of depreciation under section 167. See §§ 1.167(b)-0, 1, 2, 3, and 4 for methods of computing such depreciation allowances. If, on the other hand, the estimated useful life of such property in the hands of the taxpayer, determined without regard to the terms of the lease, would be longer than the remaining period of such lease, the allowances shall take the form of annual deductions from gross income in an amount equal to the unrecovered cost of such capital expenditures divided by the number of years remaining of the term of the lease. Such deductions shall be in lieu of allowances for depreciation. See section 162 and the regulations thereunder. Capital expenditures made by a lessor for the erection of buildings or other improvements

shall, if subject to depreciation allowances, be recovered by him over the estimated life of the improvements without regard to the period of the lease.

§ 1.167(a)-5 APPORTIONMENT OF BASIS.—In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. In the case of property which is subject to both the allowance for depreciation and amortization, depreciation is allowable only with respect to the portion of the depreciable property which is not subject to the allowance for amortization and may be taken concurrently with the allowance for amortization. After the close of the amortization period or after amortization deductions have been discontinued with respect to any such property, the unrecovered cost or other basis of the depreciable portion of such property will be subject to depreciation. For adjustments to basis, see section 1016 and other applicable provisions of law.

§ 1.167(a)-6 DEPRECIATION IN SPECIAL CASES.—(a) *Depreciation of patents or copyrights.*—The cost or other basis of a patent or copyright shall be depreciated over its remaining useful life. Its cost to the patentee includes the various Government fees, cost of drawings, models, attorneys' fees, and similar expenditures. For rules applicable to research and experimental expenditures, see sections 174 and 1016 and the regulations thereunder. If a patent or copyright becomes valueless in any year before its expiration the unrecovered cost or other basis may be deducted in that year.

(b) *Depreciation in cases of farmers.*—A reasonable allowance for depreciation may be claimed on farm buildings (except a dwelling occupied by the owner), farm machinery, and other physical property but not including land. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits in accordance with section 61 and the regulations thereunder. Such depreciation should be determined with reference to the cost or other basis, salvage value, and the estimated useful life of the livestock. See also section 162 and the regulations thereunder relating to trade or business expenses, section 165 and the regulations thereunder relating to losses of farmers, and section 175 and the regulations thereunder relating to soil or water conservation expenditures.

§ 1.167(a)-7 ACCOUNTING FOR DEPRECIABLE PROPERTY.—(a) Depreciable property may be accounted for by treating each individual item as an account, or by combining two or more assets in a single account. Assets may be grouped in an account in a variety of ways. For example, assets similar in kind with approximately the same useful lives may be grouped together. Such an account is commonly known as a group account. Another appropriate grouping might consist of assets segregated according to use without regard to useful life, for example, machinery and equipment, furniture and fixtures, or transportation equipment. Such an account is commonly known as a classified account. A broader grouping, where assets are included in

the same account regardless of their character or useful lives, is commonly referred to as a composite account. For example, all the assets used in a business may be included in a single account. Group, classified, or composite accounts may be further broken down on the basis of location, dates of acquisition, cost, character, use, etc.

(b) When group, classified, or composite accounts are used with average useful lives and a normal retirement occurs, the full cost or other basis of the asset retired, unadjusted for depreciation or salvage, shall be removed from the asset account and shall be charged to the depreciation reserve. Amounts representing salvage ordinarily are credited to the depreciation reserve. Where an asset is disposed of for reasons other than normal retirement, the full cost or other basis of the asset shall be removed from the asset account, and the depreciation reserve shall be charged with the depreciation applicable to the retired asset. For rules with respect to losses on normal retirements, see § 1.167(a)-8.

(c) A taxpayer may establish as many accounts for depreciable property as he desires. Depreciation allowances shall be computed separately for each account. Such depreciation preferably should be recorded in a depreciation reserve account; however, in appropriate cases it may be recorded directly in the asset account. Where depreciation reserves are maintained, a separate reserve account shall be maintained for each asset account. The regular books of account or permanent auxiliary records shall show for each account the basis of the property, including adjustments necessary to conform to the requirements of section 1016 and other provisions of law relating to adjustments to basis, and the depreciation allowances for tax purposes. In the event that reserves for book purposes do not correspond with reserves maintained for tax purposes, permanent auxiliary records shall be maintained with the regular books of account reconciling the differences in depreciation for tax and book purposes because of different methods of depreciation, bases, rates, salvage, or other factors. Depreciation schedules filed with the income tax return shall show the accumulated reserves computed in accordance with the allowances for income tax purposes.

(d) In classified or composite accounts, the average useful life and rate shall be redetermined whenever additions, retirements, or replacements substantially alter the relative proportion of types of assets in the accounts. See example (2) in § 1.167(b)-1(b) for a method of determining the depreciation rate for a classified or composite account.

§ 1.167(a)-8 RETIREMENTS.—(a) *Gains and losses on retirements.*—For the purposes of this section the term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation,

and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

(2) Where an asset is retired by exchange, the recognition of gain or loss will be subject to the provisions of sections 1002, 1031, 1231, and other applicable provisions of law.

(3) Where an asset is permanently retired from use in the trade or business or in the production of income but is not disposed of by the taxpayer or physically abandoned (as, for example, when the asset is transferred to a supplies or scrap account), gain will not be recognized. In such a case loss will be recognized measured by the excess of the adjusted basis of the asset at the time of retirement over the estimated salvage value or over the fair market value at the time of such retirement if greater, but only if—

(i) The retirement is an abnormal retirement, or

(ii) The retirement is a normal retirement from a single asset account (but see paragraph (d) for special rule for item accounts), or

(iii) The retirement is a normal retirement from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset contained in the account.

(4) Where an asset is retired by actual physical abandonment (as, for example, in the case of a building condemned as unfit for further occupancy or other use), loss will be recognized measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition.

Experience with assets which have attained an exceptional or unusual age shall, with respect to similar assets, be disregarded in determining the maximum expected useful life of the longest lived asset in a multiple asset account. For example, if a manufacturer establishes a proper multiple asset account for 50 assets which are expected to have an average life of 30 years but which will remain useful to him for varying periods between 20 and 40 years, the maximum expected useful life will be 40 years, even though an occasional asset of this kind may last 60 years.

(b) *Definition of normal and abnormal retirements.*—For the purpose of this section the determination of whether a retirement is normal or abnormal shall be made in the light of all the facts and circumstances. In general, a retirement shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the

normal course of events, the taxpayer customarily retires similar assets from use in his business. On the other hand, a retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(c) *Basis of assets retired.*—The basis of an asset at the time of retirement for computing gain or loss shall be its adjusted basis for determining gain or loss upon a sale or other disposition as determined in accordance with the provisions of section 1011 and the following rules:

(1) In the case of a normal retirement of an asset from a multiple asset account where the depreciation rate is based on average expected useful life, the term "adjusted basis" means the salvage value estimated in determining the depreciation deduction in accordance with the provisions of § 1.167(a)-1(c),

(2) In the case of a normal retirement of an asset from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset in the account, the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper if the asset had been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) using a rate based upon the maximum expected useful life of that asset, and

(3) In the case of an abnormal retirement from a multiple asset account the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper had the asset been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) and using a rate based upon either the average expected useful life or the maximum expected useful life of the asset, depending upon the method of determining the rate of depreciation used in connection with the multiple asset account.

(d) *Special rule for item accounts.*—(1) As indicated in paragraphs (a)(3) (ii) and (iii) of this section, a loss is recognized upon the normal retirement of an asset from a single asset account but a loss on the normal retirement of an asset in a multiple asset account is not allowable where the depreciation rate is based upon the average useful life of the assets in the account. Where a taxpayer with more than one depreciable asset chooses to set up a separate account for each such asset and the depreciation rate is based on the average useful life of such assets (so that he uses the same life for each account), the question arises whether his depreciation deductions in substance are the equivalent of those which would result from the use of multiple asset accounts and, therefore, he should be subject to the rules governing losses on retirements of assets from multiple asset accounts. Where a taxpayer has only a few depreciable assets which he chooses to account for in single asset accounts, particularly where such assets cover a relatively narrow range of lives, it cannot be said in the usual case that the allowance of losses on retirements from such accounts clearly will distort income. This results from the fact that where a taxpayer has only a few depreciable assets it is usually not possible clearly to determine that the depreciation rate is based upon

the average useful life of such assets. Accordingly, it cannot be said that the taxpayer is in effect clearly operating with a multiple asset account using an average life rate so that losses should not be allowed on normal retirements. Therefore, losses normally will be allowed upon retirement of assets from single asset accounts where the taxpayer has only a few depreciable assets. On the other hand, when a taxpayer who has only a few depreciable assets chooses to account for them in single assets accounts, using for each account a depreciation rate based on the average useful life of such assets, and the assets cover a wide range of lives, the likelihood that income will be distorted is greater than where the group of assets covers a relatively narrow range of lives. In those cases where the allowance of losses would distort income, the rules with respect to the allowance of losses on normal retirement shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(2) Where a taxpayer has a large number of depreciable assets and depreciation is based on the average useful life of such assets, then, whether such assets are similar or dissimilar and regardless of whether they are accounted for in individual asset accounts or multiple asset accounts the allowance of losses on the normal retirement of such assets would distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before the expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, if instead of accounting for a large number of similar or dissimilar depreciable assets in multiple asset accounts, the taxpayer chooses to account separately for such assets, using a rate based upon the average life of such assets, the rules with respect to the allowances of losses on normal retirements will be applied to such assets in the same manner as though the assets were accounted for in multiple asset accounts using a rate based upon average expected useful life.

(3) Where a taxpayer who does not have a large number of depreciable assets (and who therefore is not subject to subparagraph (2) of this paragraph) chooses to set up a separate account for each such asset, and has sought to compute an average life for such assets on which to base his depreciation deductions (so that he uses the same life for each account), the allowance of losses on normal retirements from such accounts may in some situations substantially distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, where a taxpayer chooses to account separately for such assets instead of accounting for them in multiple asset accounts, and the result is to substantially distort his income, the rules with respect to the allowance of losses on normal retirements shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(4) Whenever a taxpayer is treated under this paragraph as though his assets were accounted for in a multiple asset account using an

average life rate, and, therefore, he is denied a loss on retirements, the unrecovered cost less salvage of each asset which was accounted for separately may be amortized in accordance with the rule stated in paragraph (e) (1) (ii) of this section.

(e) *Accounting treatment of asset retirements.*—(1) In the case of a normal retirement where under the foregoing rules no loss is recognized and where the asset is retired without disposition or abandonment, (i) if the asset was contained in a multiple asset account, the full cost of such asset, reduced by estimated salvage, shall be charged to the depreciation reserve, or (ii) if the asset was accounted for separately, the unrecovered cost or other basis, less salvage, of the asset may be amortized through annual deductions from gross income in amounts equal to the unrecovered cost or other basis of such asset, divided by the average expected useful life (not the remaining useful life) applicable to the asset at the time of retirement. For example, if an asset is retired after six years of use and at the time of retirement depreciation was being claimed on the basis of an average expected useful life of ten years, the unrecovered cost or other basis less salvage would be amortized through equal annual deductions over a period of ten years from the time of retirement.

(2) Where multiple asset accounts are used and acquisitions and retirements are numerous, if a taxpayer, in order to avoid unnecessarily detailed accounting for individual retirements, consistently follows the practice of charging the reserve with the full cost or other basis of assets retired and of crediting it with all receipts from salvage, the practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income. Conversely, where the taxpayer customarily follows a practice of reporting all receipts from salvage as ordinary taxable income such practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income.

(f) *Cross reference.*—For special rules in connection with the retirement of the last asset of a given year's acquisitions under the declining balance method, see example (2) in § 1.167(b)-2(b).

§ 1.167(a)-9 *Obsolescence.*—The depreciation allowance includes an allowance for normal obsolescense which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supercession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of an asset is suddenly terminated, see section 165 and the regulations thereunder. If the estimated useful life and the depreciation rates

have been the subject of a previous agreement, see section 167(d) and § 1.167(d)-1.

§ 1.167(a)-10 When Depreciation Deduction Is Allowable.—(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. However, in the case of a multiple asset account, the amount of depreciation may be determined by using what is commonly described as an "averaging convention", that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. See example (3) under § 1.167(b)-1(b). Among still other averaging conventions which may be used is the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of that year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year's depreciation would be taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements in the first half of the year and a full year's depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used.

§ 1.167(b) Statutory Provisions; Depreciation; Use of Certain Methods and Rates.

SEC. 167. DEPRECIATION. * * *

(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).

§ 1.167(b)-(0) METHODS OF COMPUTING DEPRECIATION—(a) *In general.*—Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

(b) *Certain methods.*—Methods previously found adequate to produce a reasonable allowance under the Internal Revenue Code of 1939 or prior revenue laws will, if used consistently by the taxpayer, continue to be acceptable under section 167(a). Examples of such methods which continue to be acceptable are the straight line method, the declining balance method with the rate limited to 150 percent of the applicable straight line rate, and under appropriate circumstances, the unit of production method. The methods described in section 167(b) and §§ 1.167(b)-1, 2, 3, and 4 shall be deemed to produce a reasonable allowance for depreciation except as limited under section 167(c) and § 1.167(c)-1. See also § 1.167(e)-1 for rules relating to change in method of computing depreciation.

(c) *Application of methods.*—In the case of item accounts, any method which results in a reasonable allowance for depreciation may be selected for each item of property, but such method must thereafter be applied consistently to that particular item. In the case of group, classified, or composite accounts, any method may be selected for each account. Such method must be applied to that particular account consistently thereafter but need not necessarily be applied to acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts. See, however, § 1.167(e)-1 and section 446 and the regulations thereunder, for rules relating to changes in the method of computing depreciation, and, § 1.167(c)-1 for restriction on the use of certain methods. See also § 1.167(a)-7 for definition of account.

§ 1.167(b)-1 STRAIGHT LINE METHOD.—(a) *Application of method.*—Under the straight line method the cost or other basis of the

property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

(b) *Illustrations.*—The straight line method is illustrated by the following examples:

Example (1). Under the straight line method items may be depreciated separately:

Year	Item	Cost or other basis less salvage	Useful life	Depreciation allowable		
				1954	1955	1956
1954	Asset A	$1, 600	4	*$200	$400	$400
	Asset B	12, 000	40	*150	300	300

*In this example it is assumed that the assets were placed in service on July 1, 1954.

Example (2). In group, classified, or composite accounting, a number of assets with the same or different useful lives may be combined into one account, and a single rate of depreciation, i. e., the group, classified, or composite rate used for the entire account. In the case of group accounts, i. e., accounts containing assets which are similar in kind and which have approximately the same estimated useful lives, the group rate is determined from the average of the useful lives of the assets. In the case of classified or composite accounts, the classified or composite rate is generally computed by determining the amount of one year's depreciation for each item or each group of similar items, and by dividing the total depreciation thus obtained by the total cost or other basis of the assets. The average rate so obtained is to be used as long as subsequent additions, retirements, or replacements do not substantially alter the relative proportions of different types of assets in the account. An example of the computation of a classified or composite rate follows:

Cost or other basis	*Estimated useful life*	*Annual depreciation*
$10, 000	5	$2, 000
10, 000	15	667
20, 000		2, 667

Average rate is 13.33 percent ($2,667÷$20,000) unadjusted for salvage. Assuming the estimated salvage value is 10 percent of the cost or other basis, the rate adjusted for salvage will be 13.33 percent minus 10 percent of 13.33 percent (13.33%−1.33%), or 12 percent.

Example (3). The use of the straight line method for group, classified, or composite accounts is illustrated by the following example: A taxpayer filing his returns on a calendar year basis maintains an asset account for which a group rate of 20 percent has been determined, before adjustment for salvage. Estimated salvage is determined to be 6⅔ percent, resulting in an adjusted rate of 18.67 percent. During the years illustrated, the initial investment, additions, retirements, and salvage recoveries, which were determined not to change the composition of the group sufficiently to require a change in rate, were assumed to have been made as follows:

1954—Initial investment of $12,000
1957—Retirement $2,000, salvage realized $200
1958—Retirement $2,000, salvage realized $200
1959—Retirements $4,000, salvage realized $400
1959—Additions $10,000
1960—Retirement $2,000, no salvage realized
1961—Retirement $2,000, no salvage realized

Depreciable asset account and depreciation computation on average balances

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average balance	Rate	Allowable depreciation
1954		$12,000		$12,000	$6,000	18.67%	$1,120
1955	$12,000			12,000	12,000	"	2,240
1956	12,000			12,000	12,000	"	2,240
1957	12,000		$2,000	10,000	11,000	"	2,054
1958	10,000		2,000	8,000	9,000	"	1,680
1959	8,000	10,000	4,000	14,000	11,000	"	2,054
1960	14,000		2,000	12,000	13,000	"	2,427
1961	12,000		2,000	10,000	11,000	"	2,054

Corresponding depreciation reserve account

Year	Depreciation reserve Jan. 1	Depreciation allowable	Current retirements	Salvage realized	Depreciation reserve Dec. 31
1954		$1,120			$1,120
1955	$1,120	2,240			3,360
1956	3,360	2,240			5,600
1957	5,600	2,054	$2,000	$200	5,854
1958	5,854	1,680	2,000	200	5,734
1959	5,734	2,054	4,000	400	4,188
1960	4,188	2,427	2,000		4,615
1961	4,615	2,054	2,000		4,669

§ 1.167(b)-2 DECLINING BALANCE METHOD.—(a) *Application of method.*—Under the declining balance method a uniform rate is applied each year to the unrecovered cost or other basis of the property. The unrecovered cost or other basis is the basis provided by section 167(f), adjusted for depreciation previously allowed or allowable, and for all other adjustments provided by section 1016 and other applicable provisions of law. The declining balance rate may be determined without resort to formula. Such rate determined under section 167(b)(2) shall not exceed twice the appropriate straight line rate computed without adjustment for salvage. While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a rea-

sonable salvage value. See section 167(c) and §1.167(c)-1 for restrictions on the use of the declining balance method.

(b) *Illustrations.*—The declining balance method is illustrated by the following examples:

Example (1). A new asset having an estimated useful life of 20 years was purchased on January 1, 1954, for $1,000. The normal straight line rate (without adjustment for salvage) is 5 percent, and the declining balance rate at twice the normal straight line rate is 10 percent. The annual depreciation allowances for 1954, 1955, and 1956 are as follows:

Year	*Basis*	*Declining balance rate*	*Depreciation allowance*
1954	$1,000	10%	$100
1955	900	10%	90
1956	810	10%	81

Example (2). A taxpayer filing his returns on a calendar year basis maintains a group account to which a 5 year life and a 40 percent declining balance rate are applicable. Original investment, additions, retirements, and salvage recoveries are the same as those set forth in example (3) of § 1.167(b)-1(b). Although salvage value is not taken into consideration in computing a declining balance rate, it must be recognized and accounted for when assets are retired.

Depreciable asset account and depreciation computation using average asset and reserve balances

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average balance	Average reserve before depreciation	Net depreciable balance	Rate	Allowable depreciation
1954		$12,000		$12,000	$6,000		$6,000	40%	$2,400
1955	$12,000			12,000	12,000	$2,400	9,600	"	3,840
1956	12,000			12,000	12,000	6,240	5,760	"	2,304
1957	12,000		$2,000	10,000	11,000	7,644	3,356	"	1,342
1958	10,000		2,000	8,000	9,000	7,186	1,814	"	726
1959	8,000	10,000	4,000	14,000	11,000	5,212	5,788	"	2,315
1960	14,000		2,000	12,000	13,000	4,727	8,273	"	3,309
1961	12,000		2,000	10,000	11,000	6,036	4,964	"	1,986

Depreciation reserve

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31 after depreciation
1954						$2,400	$2,400
1955	$2,400			$2,400	$2,400	3,840	6,240
1956	6,240			6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	2,315	5,727
1960	5,727	2,000		3,727	4,727	3,309	7,036
1961	7,036	2,000		5,036	6,036	1,986	7,022

Where separate depreciation accounts are maintained by year of acquisition and there is an unrecovered balance at the time of the last retirement, such unrecovered balance may be deducted as part of the depreciation allowance for the year of such retirement. Thus, if

the taxpayer had kept separate depreciation accounts by year of acquisition and all the retirements shown in the example above were from 1954 acquisitions, depreciation would be computed on the 1954 and 1959 acquisitions as follows:

1954 acquisitions

Year	Asset balance Jan. 1	Acquisitions	Current retirements	Asset balance Dec. 31	Average balance	Average reserve before depreciation	Net depreciable balance	Rate	Allowable depreciation
1954		$12,000		$12,000	$6,000		$6,000	40%	$2,400
1955	$12,000			12,000	12,000	$2,400	9,600	"	3,840
1956	12,000			12,000	12,000	6,240	5,760	"	2,304
1957	12,000		$2,000	10,000	11,000	7,644	3,356	"	1,342
1958	10,000		2,000	8,000	9,000	7,186	1,814	"	726
1959	8,000		4,000	4,000	6,000	5,212	788	"	315
1960	4,000		2,000	2,000	3,000	2,727	273	"	109
1961	2,000		2,000		1,000	836	164		*164

*Balance allowable as depreciation in the year of retirement of the last survivor of the 1954 acquisitions.

Depreciation reserve for 1954 acquisitions

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31 after depreciation
1954						$2,400	$2,400
1955	$2,400			$2,400	$2,400	3,840	6,240
1956	6,240			6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	315	3,727
1960	3,727	2,000		1,727	2,727	109	1,836
1961	1,836	2,000		(164)	836	164	

1959 acquisitions

Year	Asset balance Jan. 1	Acquisition	Asset balance Dec. 31	Average balance	Reserve Dec. 31, before depreciation	Net depreciable balance	Rate	Allowable depreciation	Reserve Dec. 31, after depreciation
1959		$10,000	$10,000	$5,000	None	$5,000	40%	$2,000	$2,000
1960	$10,000		10,000	10,000	$2,000	8,000	40%	3,200	5,200
1961	10,000		10,000	10,000	5,200	4,800	40%	1,920	7,120

In the above example, the allowable depreciation on the 1954 acquisitions totals $11,200. This amount when increased by salvage realized in the amount of $800, equals the entire cost or other basis of the 1954 acquisitions ($12,000).

(c) *Change in estimated useful life.*—In the declining balance method when a change is justified in the useful life estimated for an account, subsequent computations shall be made as though the revised useful life had been originaly estimated. For example, assume that an account has an estimated useful life of ten years and that a declining balance rate of 20 percent is applicable. If, at the end of the sixth year, it is determined that the remaining useful life of the account is six years, computations shall be made as though the estimated useful life was originaly determined as twelve years. Accordingly, the ap-

plicable depreciation rate will be 16⅔ percent. This rate is thereafter applied to the unrecovered cost or other basis.

§ 1.167(b)–3 SUM OF THE YEARS-DIGITS METHOD.—(a) *Applied to a single asset.*—(1) *General rule.*—Under the sum of the years-digits method annual allowances for depreciation are computed by applying changing fractions to the cost or other basis of the property reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator which remains constant is the sum of all the years digits corresponding to the estimated useful life of the asset. See section 167(c) and § 1.167(c)–1 for restrictions on the use of the sum of the years-digits method.

(i) Illustrations.—Computation of depreciation allowances on a single asset under the sum of the years-digits method is illustrated by the following examples:

Example (1).—A new asset having an estimated useful life of five years was acquired on January 1, 1954, for $1,750. The estimated salvage is $250. For a taxpayer filing his returns on a calendar year basis, the annual depreciation allowances are as follows:

Year	*Cost or other basis less salvage*	*Fraction**	*Allowable depreciation*	*Depreciation reserve*
1954	$1,500	5/15	$500	$500
1955	1,500	4/15	400	900
1956	1,500	3/15	300	1,200
1957	1,500	2/15	200	1,400
1958	1,500	1/15	100	1,500
Unrecovered value (salvage)				250

*The denominator of the fraction is the sum of the digits representing the years of useful life, i. e., 5. 4, 3, 2, and 1, or 15.

Example (2). Assume in connection with an asset acquired in 1954 that 3/4 of a year's depreciation is allowable in that year. The following illustrates a reasonable method of allocating depreciation:

	Depreciation for 12 months	*Allowable depreciation*		
		1954	*1955*	*1956*
1st year	$500	(3/4) $375	(1/4) $125	----------
2d year	400	----------	(3/4) 300	(1/4) $100
3d year	300	----------	----------	(3/4) 225
		375	425	325

(ii) *Change in useful life.*—Where in the case of a single asset, a change is justified in the useful life, subsequent computations shall be made as though the remaining useful life at the beginning of the taxable year of change were the useful life of a new asset acquired at such time and with a basis equal to the unrecovered cost or other basis of the asset at that time. For example, assume that a new asset with an estimated useful life of ten years is purchased in 1954. At the time of making out his return for 1959, the taxpayer finds that the asset has a remaining useful life of seven years from January 1, 1959. Depreciation for 1959 should then be computed as though 1959 were the first year of the life of an asset estimated to have a useful life of seven years, and the allowance for 1959 would be 7/28 of the unrecovered cost or other basis of the asset after adjustment for salvage.

(2) *Remaining life.*—(i) *Application.*—Under the sum of the years-digits method, annual allowances for depreciation may also be computed by applying changing fractions to the unrecovered cost or other basis of the asset reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the digits corresponding to the years of estimated remaining useful life of the asset. For decimal equivalents of such fractions see Table I below. For example, a new asset with an estimated useful life of 10 years is purchased January 1, 1954, for $6,000. Assuming a salvage value of $500, the depreciation allowance for 1954 is $1,000 ($5,500×.1818, the applicable rate from Table I). For 1955, the unrecovered balance is $4,500, and the remaining life is 9 years. The depreciation allowance for 1955 would then be $900 ($4,500×.2000, the applicable rate from Table I).

(ii) *Table I.*—This table shows decimal equivalents of sum of the years digits fractions corresponding to remaining lives from 1 to 100 years.

TABLE I.—DECIMAL EQUIVALENT FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE

Remaining life (years)	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*
100.0	0. 0198	96.3	0. 0206	92.6	0. 0214	88.9	0. 0222
99.9	. 0198	96.2	. 0206	92.5	. 0214	88.8	. 0223
99.8	. 0198	96.1	. 0206	92.4	. 0214	88.7	. 0223
99.7	. 0199	96.0	. 0206	92.3	. 0214	88.6	. 0223
99.6	. 0199	95.9	. 0206	92.2	. 0215	88.5	. 0223
99.5	. 0199	95.8	. 0207	92.1	. 0215	88.4	. 0224
99.4	. 0199	95.7	. 0207	92.0	. 0215	88.3	. 0224
99.3	. 0199	95.6	. 0207	91.9	. 0215	88.2	. 0224
99.2	. 0200	95.5	. 0207	91.8	. 0216	88.1	. 0224
99.1	. 0200	95.4	. 0207	91.7	. 0216	88.0	. 0225
99.0	. 0200	95.3	. 0208	91.6	. 0216	87.9	. 0225
98.9	. 0200	95.2	. 0208	91.5	. 0216	87.8	. 0225
98.8	. 0200	95.1	. 0208	91.4	. 0216	87.7	. 0225
98.7	. 0201	95.0	. 0208	91.3	. 0217	87.6	. 0226
98.6	. 0201	94.9	. 0209	91.2	. 0217	87.5	. 0226
98.5	. 0201	94.8	. 0209	91.1	. 0217	87.4	. 0226
98.4	. 0201	94.7	. 0209	91.0	. 0217	87.3	. 0226
98.3	. 0201	94.6	. 0209	90.9	. 0218	87.2	. 0227
98.2	. 0202	94.5	. 0209	90.8	. 0218	87.1	. 0227
98.1	. 0202	94.4	. 0210	90.7	. 0218	87.0	. 0227
98.0	. 0202	94.3	. 0210	90.6	. 0218	86.9	. 0228
97.9	. 0202	94.2	. 0210	90.5	. 0219	86.8	. 0228
97.8	. 0202	94.1	. 0210	90.4	. 0219	96.7	. 0228
97.7	. 0203	94.0	. 0211	90.3	. 0219	86.6	. 0228
97.6	. 0203	93.9	. 0211	90.2	. 0219	86.5	. 0229
97.5	. 0203	93.8	. 0211	90.1	. 0220	86.4	. 0229
97.4	. 0203	93.7	. 0211	90.0	. 0220	86.3	. 0229
97.3	. 0203	93.6	. 0211	89.9	. 0220	86.2	. 0229
97.2	. 0204	93.5	. 0212	89.8	. 0220	86.1	. 0230
97.1	. 0204	93.4	. 0212	89.7	. 0221	86.0	. 0230
97.0	. 0204	93.3	. 0212	89.6	. 0221	85.9	. 0230
96.9	. 0204	93.2	. 0212	89.5	. 0221	85.8	. 0230
96.8	. 0204	93.1	. 0213	89.4	. 0221	85.7	. 0231
96.7	. 0205	93.0	. 0213	89.3	. 0221	85.6	. 0231
96.6	. 0205	92.9	. 0213	89.2	. 0222	85.5	. 0231
96.5	. 0205	92.8	. 0213	89.1	. 0222	85.4	. 0231
96.4	. 0205	93.7	. 0213	89.0	. 0222	85.3	. 0232

TABLE I.—DECIMAL EQUIVALENT FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent	Remaining life (years)	Decimal equivalent	Remaining life (years)	Decimal equivalent	Remaining life (years)	Decimal equivalent
85.2	0. 0232	79.2	0. 0249	73.2	0. 0270	67.2	0. 0293
85.1	.0232	79.1	.0250	73.1	.0270	67.1	.0294
85.0	.0233	79.0	.0250	73.0	.0270	67.0	.0294
84.9	.0233	78.9	.0250	72.9	.0271	66.9	.0295
84.8	.0233	78.8	.0251	72.8	.0271	66.8	.0295
84.7	.0233	78.7	.0251	72.7	.0271	66.7	.0295
84.6	.0234	78.6	.0251	72.6	.0272	66.6	.0296
84.5	.0234	78.4	.0252	72.5	.0272	66.5	.0296
84.4	.0234	78.5	.0252	72.4	.0272	66.4	.0297
84.3	.0234	78.3	.0252	72.3	.0273	66.3	.0297
84.2	.0235	78.2	.0253	72.2	.0273	66.2	.0298
84.1	.0235	78.1	.0253	72.1	.0274	66.1	.0298
84.0	.0235	78.0	.0253	72.0	.0274	66.0	.0299
83.9	.0236	77.9	.0253	71.9	.0274	65.9	.0299
83.8	.0236	77.8	.0254	71.8	.0275	65.8	.0299
83.7	.0236	77.7	.0254	71.7	.0275	65.7	.0300
83.6	.0236	77.6	.0254	71.6	.0275	65.6	.0300
83.5	.0237	77.5	.0255	71.5	.0276	65.5	.0301
83.4	.0237	77.4	.0255	71.4	.0276	65.4	.0301
83.3	.0237	77.3	.2955	71.3	.0277	65.3	.0302
83.2	.0238	77.2	.0256	71.2	.0277	65.2	.0302
83.1	.0238	77.1	.0256	71.1	.0277	65.1	.0303
83.0	.0238	77.0	.0256	71.0	.0278	65,0	.0303
82.9	.0238	76.9	.0257	70.9	.0278	64.9	.0303
82.8	.0239	76.8	.0257	70.8	.0279	64.8	.0304
82.7	.0239	76.7	.0257	70.7	.0279	64.7	.0304
82.6	.0239	76.6	.0258	70.6	.0279	64.6	.0305
82.5	.0240	76.5	.0258	70.5	.0280	64.5	.0305
82.4	.0240	76.4	.0258	70.4	.0280	64.4	.0306
82.3	.0240	76.3	.0259	70.3	.0280	64.3	.0306
82.2	.0240	76.2	.0259	70.2	.0281	64,2	.0307
82.1	.0241	76.1	.0259	70.1	.0281	64.1	.0307
82.0	.0241	76.0	.0260	70.0	.0282	64.0	.0308
81.9	.0241	75.9	.0260	69.9	.0282	63.9	.0308
81.8	.0242	75.8	.0260	69.8	.0282	63.8	.0309
81.7	.0242	75.7	.0261	69.7	.0283	63.7	.0309
81.6	.0242	75.6	.0261	69.6	.0283	63.6	.0310
81.5	.0242	75.5	.0261	69.5	.0284	63.5	.0310
81.4	.0243	75.4	.0262	69.4	.0284	63.4	.0311
81.3	.0243	75.3	.0262	69.3	.0284	63.3	.0311
81.2	.0243	75.2	.0262	69.2	.0285	63.2	.0312
81.1	.0244	75.1	.0263	69.1	.0285	63.1	.0312
81.0	.0244	75.0	.0263	69,0	.0286	63.0	.0313
80.9	.0244	74.9	.0264	68.9	.0286	62.9	.0313
80.8	.0244	74.8	.0264	68.8	.0287	62.8	.0313
80.7	.0245	74.7	.0264	68.7	.0287	62.7	.0314
80.6	.0245	74.6	.0265	68.6	.0287	62,6	.0314
80.5	.0245	74.5	.0265	68.5	.0288	62.5	.0315
80.4	.0246	74.4	.0265	68.4	.0288	62.4	.0315
80.3	.0246	74.3	.0266	68.3	.0289	62.3	.0316
80.2	.0246	74.2	.0266	68.2	.0289	62.2	.0316
80.1	.0247	74.1	.0266	68.1	.0289	62.1	.0317
80.0	.0247	74.0	.0267	68,0	.0290	62.0	.0317
79.9	.0247	73.9	.0267	67.9	.0290	61.9	.0318
79.8	.0248	73.8	.0267	67.8	.0291	61.8	.0318
79.7	.0248	73.7	.0268	67.7	.0291	61.7	.0319
79.6	.0248	73.6	.0268	67.6	.0292	61.6	.0319
79.5	.0248	73.5	.0268	67.5	.0292	61.5	.0320
79.4	.0249	73.4	.0269	67.4	.0292	61.4	.0320
79.3	.0249	73.3	.0269	67.3	.0293	61.3	.0321

TABLE I.—DECIMAL EQUIVALENT FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent	Remaining life (years)	Decimal equivalent	Remaining life (years)	Decimal equivalent	Remaining life (years)	Decimal equivalent
61 2	0. 0322	55.2	0. 0356	49.2	0. 0398	43.2	0. 0452
61.1	. 0322	55.1	. 0356	49.1	. 0399	43.1	. 0453
61.0	. 0323	55.0	0357	49.0	. 0400	43.0	. 0455
60.9	. 0323	54.9	. 0358	48.9	. 0401	42.9	. 0456
60.8	. 0324	54.8	. 0358	48.8	. 0402	42.8	. 0457
60.7	. 0324	54.7	. 0359	48.7	0402	42.7	. 0458
60.6	. 0325	54.6	. 0360	48.6	. 0403	42.6	. 0459
60.5	. 0325	54.5	. 0360	48.5	. 0404	42.5	. 0460
60.4	. 0326	54.4	. 0361	48.4	. 0405	42.4	. 0461
60.3	. 0326	54.3	. 0362	48.3	. 0406	42.3	0462
60.2	. 0327	54.2	. 0362	48.2	. 0406	42.2	. 0463
60.1	. 0327	54.1	. 0363	48.1	. 0407	42.1	. 0464
60.0	. 0328	54.0	. 0364	48.0	. 0408	42.0	. 0465
59.9	. 0328	53.9	. 0364	47.9	. 0409	41.9	0466
59.8	. 0329	53.8	. 0365	47.8	. 0410	41.8	. 0467
59.7	. 0329	53.7	. 0366	47.7	. 0411	41.7	. 0468
59.6	. 0330	53.6	. 0366	47.6	. 0411	41.6	. 0469
59.5	. 0331	53.5	. 0367	47.5	. 0412	41.5	. 0471
59.4	. 0331	53.4	. 0368	47.4	. 0413	41.4	. 0472
59.3	. 0332	53.3	0368	47.3	. 0414	41.3	. 0473
59.2	. 0332	53.2	. 0369	47.2	. 0415	41.2	. 0474
59.1	. 0333	53.1	. 0370	47.1	0416	41.1	. 0475
59.0	. 0333	53.0	. 0370	47.0	. 0417	41.0	. 0476
58.9	. 0334	52.9	. 0371	46.9	. 0418	40.9	. 0477
58.8	. 0334	52.8	. 0372	46.8	. 0418	40.8	. 0478
58.7	. 0335	52.7	. 0372	46.7	0419	40.7	. 0480
58.6	. 0336	52.6	0373	46.6	. 0420	40.6	0481
58.5	. 0336	52.5	. 0374	46.5	. 0421	40.5	. 0482
58.4	. 0337	52.4	. 0374	46.4	. 0422	40.4	. 0483
58.3	. 0337	52.3	. 0375	46.3	. 0423	40.3	. 0484
58.2	. 0338	52.2	. 0376	46.2	. 0424	40.2	. 0485
58.1	0338	52.1	. 0377	46.1	. 0425	40.1	. 0487
58.0	. 0339	52.0	. 0377	46.0	. 0426	40.0	. 0488
57.9	. 0340	51.9	. 0378	45.9	. 0426	39.9	. 0489
57.8	. 0340	51.8	. 0379	45.8	. 0427	39.8	. 0490
57.7	. 0341	51.7	. 0379	45.7	. 0428	39.7	. 0491
57.6	. 0341	51.6	. 0380	45.6	. 0429	39.6	. 0493
57.5	. 0342	51.5	0381	45.5	. 0430	39.5	. 0494
57.4	. 0342	51.4	. 0382	45.4	. 0431	39.4	. 0495
57.3	. 0343	51.3	. 0382	45.3	. 0432	39.3	. 0496
57.2	. 0344	51.2	. 0383	45.2	. 0433	39.2	. 0497
57.1	. 0344	51.1	. 0384	45.1	. 0434	39.1	. 0499
57.0	. 0345	51.0	. 0385	45.0	. 0435	39.0	. 0500
56.9	. 0345	50.9	. 0385	44.9	. 0436	38.9	. 0501
56.8	. 0346	50.8	. 0386	44.8	. 0437	38.8	. 0502
56.7	. 0347	50.7	. 0387	44.7	. 0438	38.7	. 0504
56.6	. 0347	50.6	. 0388	44.6	. 0439	38.6	. 0505
56.5	. 0348	50.5	. 0388	44.5	. 0440	38.5	. 0506
56.4	. 0348	50.4	. 0389	44.4	. 0440	38.4	. 0508
56.3	. 0349	50.3	. 0390	44.3	. 0441	38.3	. 0509
56.2	. 0350	50.2	. 0391	44.2	. 0442	38.2	. 0510
56.1	. 0350	50.1	. 0391	44.1	. 0443	38 1	. 0511
56.0	. 0351	50.0	. 0392	44.0	. 0444	38.0	. 0513
55.9	. 0351	49.9	. 0393	43.9	. 0445	37.9	. 0514
55.8	. 0352	49.8	. 0394	43.8	. 0446	37.8	. 0515
55.7	. 0353	49.7	. 0394	43.7	0447	37.7	. 0517
55.6	. 0353	49.6	. 0395	43.6	. 0448	37.6	. 0518
55.5	. 0354	49.5	. 0396	43.5	. 0449	37.5	. 0519
55.4	. 0355	49.4	. 0397	43.4	. 0450	37.4	0521
55.3	. 0355	49.3	0398	43.3	. 0451	37.3	. 0522

TABLE I.—DECIMAL EQUIVALENT FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*
37.2	0. 0524	31.2	0. 0621	25.2	0. 0763	19.2	0. 0990
37.1	. 0525	31.1	. 0623	25.1	. 0766	19.1	. 0995
37.0	. 0526	31.0	. 0625	25.0	. 0769	19.0	. 1000
36.9	. 0528	30.9	. 0627	24.9	. 0772	18.9	. 1005
36.8	. 0529	30.8	. 0629	24.8	. 0775	18.8	. 1010
36.7	. 0530	30.7	. 0631	24.7	. 0778	18.7	. 1015
36.6	. 0532	30.6	. 0633	24.6	. 0781	18.6	. 1020
36.5	. 0533	30.5	. 0635	24.5	. 0784	18.5	. 1025
36.4	. 0535	30.4	. 0637	24.4	. 0787	18.4	. 1030
36.3	. 0536	30.3	. 0639	24.3	. 0790	18.3	. 1036
36.2	. 0538	30.2	. 0641	24.2	. 0793	18.2	. 1041
36.1	. 0539	30.1	. 0643	24.1	. 0797	18.1	. 1047
36.0	. 0541	30.0	. 0645	24.0	. 0800	18.0	. 1053
35.9	. 0542	29.9	. 0647	23.9	. 0803	17.9	. 1058
35.8	. 0543	29.8	. 0649	23.8	. 0806	17.8	. 1063
35.7	. 0545	29.7	. 0651	23.7	. 0809	17.7	. 1069
35.6	. 0546	29.6	. 0653	23.6	. 0813	17.6	. 1074
35.5	. 0548	29.5	. 0656	23.5	. 0816	17.5	. 1080
35.4	. 0549	29.4	. 0658	23.4	. 0819	17.4	. 1086
35.3	. 0551	29.3	. 0660	23.3	. 0823	17.3	. 1092
35.2	. 0552	29.2	. 0662	23.2	. 0826	17.2	. 1098
35.1	. 0554	29.1	. 0664	23.1	. 0830	17.1	. 1105
35.0	. 0556	29.0	. 0667	23.0	. 0833	17.0	. 1111
34.9	. 0557	28.9	. 0669	22.9	. 0837	16.9	. 1117
34.8	. 0559	28.8	. 0671	22.8	. 0840	16.8	. 1123
34.7	. 0560	28.7	. 0673	22.7	. 0844	16.7	. 1129
34.6	. 0562	28.6	. 0675	22.6	. 0847	16.6	. 1135
34.5	. 0563	28.5	. 0678	22.5	. 0851	16.5	. 1142
34.4	. 0565	28.4	. 0680	22.4	. 0854	16.4	. 1148
34.3	. 0566	28.3	. 0682	22.3	. 0858	16.3	. 1155
34.2	. 0568	28.2	. 0685	22.2	. 0862	16.2	. 1162
34.1	. 0570	28.1	. 0687	22.1	. 0866	16.1	. 1169
34.0	. 0571	28.0	. 0690	22.0	. 0870	16.0	. 1176
33.9	. 0573	27.9	. 0692	21.9	. 0873	15.9	. 1183
33.8	. 0575	27.8	. 0694	21.8	. 0877	15.8	. 1190
33.7	. 0576	27.7	. 0697	21.7	. 0881	15.7	. 1197
33.6	. 0578	27.6	. 0699	21.6	. 0885	15.6	. 1204
33.5	. 0580	27.5	. 0702	21.5	. 0888	15.5	. 1211
33.4	. 0581	27.4	. 0704	21.4	. 0892	15.4	. 1218
33.3	. 0583	27.3	. 0707	21.3	. 0896	15.3	. 1226
33.2	. 0585	27.2	. 0709	21.2	. 0901	15.2	. 1234
33.1	. 0586	27.1	. 0712	21.1	. 0905	15.1	. 1242
33.0	. 0588	27.0	. 0714	21.0	. 0909	15.0	. 1250
32.9	. 0590	26.9	. 0717	20.9	. 0913	14.9	. 1257
32.8	. 0592	26.8	. 0719	20.8	. 0917	14.8	. 1265
32.7	. 0593	26.7	. 0722	20.7	. 0921	14.7	. 1273
32.6	. 0595	26.6	. 0724	20.6	. 0925	14.6	. 1281
32.5	. 0597	26.5	. 0727	20.5	. 0930	14.5	. 1289
32.4	. 0599	26.4	. 0730	20.4	. 0934	14.4	. 1297
32.3	. 0600	26.3	. 0732	20.3	. 0939	14.3	. 1306
32.2	. 0602	26.2	. 0735	20.2	. 0943	14.2	. 1315
32.1	. 0604	26.1	. 0738	20.1	. 0948	14.1	. 1324
32.0	. 0606	26.0	. 0741	20.0	. 0952	14.0	. 1333
31.9	. 0608	25.9	. 0743	19.9	. 0957	13.9	. 1342
31.8	. 0610	25.8	. 0746	19.8	. 0961	13.8	. 1350
31.7	. 0611	25.7	. 0749	19.7	. 0966	13.7	. 1359
31.6	. 0613	25.6	. 0752	19.6	. 0970	13.6	. 1368
31.5	. 0615	25.5	. 0754	19.5	. 0975	13.5	. 1378
31.4	. 0617	25.4	. 0757	19.4	. 0980	13.4	. 1387
31.3	. 0619	25.3	. 0760	19.3	. 0985	13.3	. 1397

TABLE I.—DECIMAL EQUIVALENT FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*
13.2	0. 1407	10.1	0. 1800	7.0	0. 2500	3.9	0. 4063
13.1	. 1418	10.0	. 1818	6.9	. 2527	3.8	. 4130
13.0	. 1429	9.9	. 1833	6.8	. 2556	3.7	. 4205
12.9	. 1438	9.8	. 1849	6.7	. 2587	3.6	. 4286
12.8	. 1448	9.7	. 1865	6.6	. 2619	3.5	. 4375
12.7	. 1458	9.6	. 1882	6.5	. 2653	3.4	. 4474
12.6	. 1469	9.5	. 1900	6.4	. 2689	3.3	. 4583
12.5	. 1479	9.4	. 1918	6.3	. 2727	3.2	. 4706
12.4	. 1490	9.3	. 1938	6.2	. 2768	3.1	. 4844
12.3	. 1502	9.2	. 1957	6.1	. 2811	3.0	. 5000
12.2	. 1514	9.1	. 1978	6.0	. 2857	2.9	. 5088
12.1	. 1526	9.0	. 2000	5.9	. 2892	2.8	. 5185
12.0	. 1538	8.9	. 2018	5.8	. 2929	2.7	. 5294
11.9	. 1549	8.8	. 2037	5.7	. 2969	2.6	. 5417
11.8	. 1561	8.7	. 2057	5.6	. 3011	2.5	5556
11.7	. 1573	8.6	. 2077	5.5	. 3056	2.4	. 5714
11.6	. 1585	8.5	. 2099	5.4	. 3103	2.3	. 5897
11.5	. 1597	8.4	. 2121	5.3	. 3155	2.2	. 6111
11.4	. 1610	8.3	. 2145	5.2	. 3210	2.1	. 6364
11.3	. 1624	8.2	. 2169	5.1	. 3269	2.0	. 6667
11.2	. 1637	8.1	. 2195	5.0	. 3333	1.9	. 6786
11.1	. 1652	8.0	. 2222	4.9	. 3379	1.8	. 6923
11.0	. 1667	7.9	. 2244	4.8	. 3429	1.7	. 7083
10.9	. 1680	7.8	. 2267	4.7	. 3481	1.6	. 7273
10.8	. 1693	7.7	. 2292	4.6	. 3538	1.5	. 7500
10.7	. 1707	7.6	. 2317	4.5	. 3600	1.4	. 7778
10.6	. 1721	7.5	. 2344	4.4	. 3667	1.3	. 8125
10.5	. 1736	7.4	. 2372	4.3	. 3739	1.2	. 8571
10.4	. 1751	7.3	. 2401	4.2	. 3818	1.1	. 9167
10.3	. 1767	7.2	. 2432	4.1	. 3905	1.0	1. 0000
10.2	. 1783	7.1	. 2465	4.0	. 4000		

NOTE: For determination of decimal equivalents of remaining lives falling between those shown in the above table, the taxpayer may use the next longest life shown in the table, interpolate from the table, or use the following formula from which the table was derived.

$$D=\frac{2R}{(W+2F)\ (W+1)}$$

Where D = Decimal equivalent
R = Remaining life
W = Whole number of years in remaining life
F = Fractional part of year in remaining life

If the taxpayer desires to carry his calculations of decimal equivalents to a greater number of decimal places than is provided in the table, he may use the formula. The procedure adopted must be consistently followed thereafter.

(b) *Applied to group, classified, or composite accounts.*—(1) *General rule.*—The sum of the years-digits method may be applied to group, classified, or composite accounts in accordance with the plan described in subparagraph (2) or in accordance with other plans as explained in subparagraph (3).

(2) *Remaining life plan.*—The remaining life plan as applied to a single asset is described in § 1.167(b)-3(a)(2). This plan may also be applied to group, classified, or composite accounts. Under this plan the allowance for depreciation is computed by applying changing fractions to the unrecovered cost or other basis of the account reduced by estimated salvage. The numerator of the fraction changes each

Depreciation computations on a group account under remaining life plan

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14
											Sum of the Years Digits Depreciation			
	Asset balance Jan. 1	Current additions	Current retirements	Average asset balance	Straight line amount	Straight line reserve	Remaining life	Asset balance reduced by salvage	Current additions reduced by salvage	Salvage realized	Accumulated reserve Jan. 1	Unrecovered Jan. 1	Rate based on Col. (7) from Table I	Allowable depreciation
					Col. (4) ÷ life	Col. (5) − Col. (3) accumulated Jan. 1	[Col. (1) − Col. (6) ÷ Col. (1)] × average service life	Col. (1) × (100% − 6.67%)	Col. (2) × (100% − 6.67%)		Prior reserve + Col. (14) + Col. (10) − Col. (3)	Col. (8) − Col. (11)		Col. (12) × Col. (13) + ½ Col. (9) × F [2]
1954		$12,000		$6,000	[1] $1,200		5.00		$11,200				0.3333	$1,866
1955	$12,000			12,000	2,400	$1,200	4.50	$11,200			$1,866	$9,334	.3600	3,360
1956	12,000			12,000	2,400	3,600	3.50	11,200			5,226	5,974	.4375	2,614
1957	12,000		$2,000	11,000	2,200	6,000	2.50	11,200		$200	7,840	3,360	.5556	1,867
1958	10,000		2,000	9,000	1,800	6,200	1.90	9,333		200	7,907	1,426	.6786	968
1959	8,000	10,000	4,000	11,000	2,200	6,000	1.25	7,466	9,333	400	7,075	391	.8125	1,874
1960	14,000		2,000	13,000	2,600	4,200	3.50	13,066			5,349	7,717	.4375	3,376
1961	12,000		2,000	11,000	2,200	4,800	3.00	11,200			6,725	4,475	.5000	2,238
1962						5,000					6,963			

[1] ½ year's amount.

[2] F = Rate based on average service life (0.3333 in this example).

year to a number which corresponds to the remaining useful life of the account (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the years digits corresponding to the years of estimated remaining useful life of the account. Decimal equivalents of such fractions can be obtained by use of Table I under § 1.167(b)-3(a)(2)(ii). The proper application of this method requires that the estimated remaining useful life of the account be determined each year. This determination, of course, may be made each year by analysis, i. e., by determining the remaining lives for each of the components in the account, and averaging them. The estimated remaining life of any account, however, may also be determined arithmetically. For example, it may be computed by dividing the unrecovered cost or other basis of the account, as computed by straight line depreciation, by the gross cost or other basis of the account, and multiplying the result by the average life of the assets in the account. Salvage value is not a factor for the purpose of determining remaining life. Thus, if a group account with an average life of ten years had at January 1, 1958, a gross asset balance of $12,600 and a depreciation reserve computed on the straight line method of $9,450, the remaining life of the account at January 1, 1958, would be computed as follows:

$$\frac{\$12,600-\$9,450}{\$12,600} \text{ times 10 years equals 2.50 years.}$$

(i) *Example.* The use of the sum of the years-digits method with group, classified, or composite accounts under the remaining life plan is illustrated by the following example: A calendar year taxpayer maintains a group account to which a five-year life is applicable. Original investment, additions, retirements, and salvage recoveries are the same as those set forth in example (3) of § 1.167(b)-1(b).

(3) *Other plans for application of the sum of the years-digits method.*—Taxpayers who wish to use the sum of the years-digits method in computing depreciation for group, classified, or composite accounts in accordance with a sum of the years digits plan other than the remaining life plan described herein may do so only with the consent of the Commissioner. Request for permission to use plans other than that described shall be addressed to the Commissioner of Internal Revenue, Washington 25, D. C.

§ 1.167(b)-4 Other Methods.—(a) Under section 167(b)(4) a taxpayer may use any consistent method of computing depreciation, such as the sinking fund method, provided depreciation allowances computed in accordance with such method do not result in accumulated allowances at the end of any taxable year greater than the total of the accumulated allowances which could have resulted from the use of the declining balance method described in section 167(b)(2). This limitation applies only during the first two-thirds of the useful life of the property. For example, an asset costing $1,000 having a useful life of six years may be depreciated under the declining balance method in accordancee with § 1.167(b)-2, at a rate of 33⅓ percent. During the first four years or 2/3 of its useful life, maximum depreciation allowances under the declining balance method would be as follows:

	Current depreciation	Accumulated depreciation	Balance
Cost of asset			$1,000
1st year	$333	$333	667
2d year	222	555	445
3d year	148	703	297
4th year	99	802	198

An annual allowance computed by any other method under section 167(b)(4) could not exceed $333 for the first year, and at the end of the second year the total allowances for the two years could not exceed $555. Likewise, the total allowances for the three years could not exceed $703 and for the four years could not exceed $802. This limitation would not apply in the fifth and sixth years. See section 167(c) and § 1.167(c)–1 for restrictions on the use of certain methods.

(b) It shall be the responsibility of the taxpayer to establish to the satisfaction of the Commissioner that a method of depreciation under section 167(b)(4) is both a reasonable and consistent method and that it does not produce depreciation allowances in excess of the amount permitted under the limitations provided in such section.

§ 1.167(c) Statutory Provisions; Depreciation; Limitations on Use of Certain Methods and Rates.

SEC. 167. DEPRECIATION. * * *

(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.

§ 1.167(c)–1 Limitations on Methods of Computing Depreciation Under Section 167(b)(2), (3), and (4).—(a) *In general.*—(1) Section 167(c) provides limitations on the use of the declining balance method described in section 167(b)(2), the sum of the years-digits method described in section 167(b)(3), and certain other methods authorized by section 167(b)(4). These methods are applicable only to tangible property having a useful life of three years or more. If construction, reconstruction, or erection by the taxpayer began before January 1, 1954, and was completed after December 31, 1953, these methods apply only to that portion of the basis of the property which is properly attributable to such construction, reconstruction, or erection after December 31, 1953. Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. The portion of the basis of such property attributable to construction, reconstruction, or erection after December 31, 1953, consists of all costs of the property allocable to the period after December 31, 1953, including the cost or other basis of materials entering into such work. It is not necessary that such materials be acquired after December 31, 1953, or that they be new in use. If construction or erection by the taxpayer began after December 31, 1953, the entire cost or other basis of such construction or erection qualifies for these methods of depreciation. In

the case of reconstruction of property, these methods do not apply to any part of the adjusted basis of such property on December 31, 1953. For purposes of this section, construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(2) If the property was not constructed, reconstructed, or erected by the taxpayer, these methods apply only if it was acquired after December 31, 1953, and if the original use of the property commences with the taxpayer and commences after December 31, 1953. For the purpose of the preceding sentence, property shall be deemed to be acquired when reduced to physical possession, or control. The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired after December 31, 1953, will not be treated as being put to original use by the taxpayer even though it is put to a different use, nor will a horse acquired for breeding purposes be treated as being put to original use by the taxpayer if prior to the purchase the horse was used for racing purposes. See §§ 1.167(b)–2, 3, and 4 for application of the various methods.

(3) Assets having an estimated average useful life of less than three years shall not be included in a group, classified, or composite account to which the methods described in §§ 1.167(b)–2, 3, and 4 are applicable. However, an incidental retirement of an asset from such an account prior to the expiration of a useful life of three years will not prevent the application of these methods to such an account.

(4) See section 381(c)(6) and the regulations thereunder for rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions.

(5) See section 1502 and § 1.1502–46 for the rule covering depreciation of property received by a member of an affiliated group from another member of the group during a consolidated return period.

(6) Except in the cases described in subparagraphs (4) and (5) of this paragraph, the methods of depreciation described in §§ 1.167(b)–2, 3, and 4 are not applicable to property in the hands of a distributee, vendee, transferee, donee, or grantee unless the original use of the property begins with such person and the conditions required by section 167(c) and this section are otherwise met. For example, these methods of depreciation may not be used by a corporation with respect to property which it acquires from an individual or partnership in exchange for its stock. Similarly, if an individual or partnership receives property in a distribution upon dissolution of a corporation, these methods of depreciation may not be used with respect to property so acquired by such individual or partnership. As a further example, these methods of depreciation may not be used by a partnership with respect to contributed property, nor by a partner with respect to partnership property distributed to him. Moreover, where a partnership is entitled to use these depreciation methods, and the optional adjustment to basis of partnership property provided by section 743 is applicable, (i) in the case of an increase in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall not be entitled to use such methods with respect to such increase, and (ii) in the case of a decrease

in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall include in his income an amount equal to the portion of the depreciation deducted by the partnership which is attributable to such decrease.

(b) *Illustrations.*—The application of these methods to property constructed, reconstructed, or erected by the taxpayer after December 31, 1953, may be illustrated by the following examples:

Example (1). If a building with a total cost of $100,000 is completed after December 31, 1953, and the portion attributable to construction after December 31, 1953, is determined by engineering estimates or by cost accounting records to be $30,000, the methods referred to in paragraph (a)(1) above, are applicable only to the $30,000 portion of the total.

Example (2). In 1954, a taxpayer has an old machine with an unrecovered cost of $1,000. If he contracts to have it reconditioned, or reconditions it himself, at a cost of an additional $5,000, only the $5,000 may be depreciated under the methods referred to in paragraph (a)(1) above, whether or not the materials used for reconditioning are new in use.

Example (3). A taxpayer who acquired a building in 1940 makes major maintenance or repair expenditures in 1954 of a type which must be capitalized. For these expenditures the taxpayer may use a method of depreciation different from that used on the building (for example, the methods referred to in paragraph (a)(1) above) only if he accounts for such expenditures separately from the account which contained the original building. In such case, the unadjusted basis on any parts replaced shall be removed from the asset account and shall be charged to the appropriate depreciation reserve account. In the alternative he may capitalize such expenditures by charging them to the depreciation reserve account for the building.

(2) The application of these methods to property which was not constructed, reconstructed, or erected by the taxpayer but which was acquired after December 31, 1953, may be illustrated by the following examples:

Example (1). A taxpayer contracted in 1953 to purchase a new machine which he acquired in 1954 and put into first use in that year. He may use the methods referred to in paragraph (a)(1) above, in recovering the cost of the new machine.

Example (2). A taxpayer instead of reconditioning his old machine buys a "factory reconditioned" machine in 1954 to replace it. He cannot apply the methods referred to in paragraph (a)(1) above, to any part of the cost of the reconditioned machine since he is not the first user of the machine.

Example (3). In 1954, a taxpayer buys a house for $20,000 which had been used as a personal residence and thus had not been subject to depreciation allowances. He makes a capital addition of $5,000 and rents the property to another. The taxpayer may use the methods referred to in paragraph (a)(1) above, only with respect to the $5,000 cost of the addition.

(c) *Election to use methods.*—Subject to the limitations set forth in paragraph (a) above, the methods of computing the allowance for

depreciation specified in section 167(b) (2), (3), and (4) may be adopted without permission and no formal election is required. In order for a taxpayer to elect to use these methods for any property described in paragraph (a) above, he need only compute depreciation thereon under any of these methods for any taxable year ending after December 31, 1953, in which the property may first be depreciated by him. The election with respect to any proeprty shall not be binding with respect to acquisitions of similar property in the same year or subsequent year which are set up in separate accounts. If a taxpayer has filed his return for a taxable year ending after December 31, 1953, for which the return is required to be filed on or before September 15, 1956, an election to compute the depreciation allowance under any of the methods specified in section 167(b) or a change in such an election may be made in an amended return or claim for refund filed on or before September 15, 1956.

§ 1.167(d) STATUTORY PROVISIONS; DEPRECIATION; AGREEMENT AS TO USEFUL LIFE ON WHICH DEPRECIATION RATE IS BASED.

SEC. 167. DEPRECIATION. * * *

(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.

§ 1.167(d)–1 AGREEMENT AS TO USEFUL LIFE AND RATES OF DEPRECIATION. After August 16, 1954, a taxpayer may, for taxable years ending after December 31, 1953, enter into an agreement with respect to the estimated useful life, method and rate of depreciation, and treatment of salvage of any property which is subject to the allowance for depreciation. An application for such agreement may be made to the district director of internal revenue for the district in which the taxpayer's return is required to be filed. Such application shall be filed in quadruplicate and shall contain in such detail as may be practical the following information:

(a) The character and location of the property.

(b) The original cost or other basis and date of acquisition.

(c) Proper adjustments to the basis including depreciation accumulated to the first taxable year to be covered by the agreement.

(d) Estimated useful life and estimated salvage value.

(e) Method and rate of depreciation.

(f) Any other facts and circumstances pertinent to making a reasonable estimate of the useful life of the property and its salvage value.

The agreement must be in writing and must be signed by the taxpayer and by the district director. The agreement must be signed in quadruplicate, and two of the signed copies will be returned to the

taxpayer. The agreement shall set forth its effective date, the estimated remaining useful life, the estimated salvage value, and rate and method of depreciation of the property and the facts and circumstances taken into consideration in adoption of the agreement, and shall relate only to depreciation allowances for such property on and after the effective date of the agreement. Such an agreement shall be binding on both parties until such time as facts and circumstances which were not taken into account in making the agreement are shown to exist. The party wishing to modify or change the agreement shall have the responsibility of establishing the existence of such facts and circumstances. Any change in the useful life or rate specified in such agreement shall be effective only prospectively, that is, it shall be effective beginning with the taxable year in which notice of the intention to change, including facts and circumstances warranting the adjustment of useful life and rate, is sent by registered mail by the party proposing the change to the other party. A copy of the agreement (and any modification thereof) shall be filed with the taxpayer's return for the first taxable year which is affected by the agreement (or any modification thereof). A signed copy should be retained with the permanent records of the taxpayer. For rules relating to changes in method of depreciation, see § 1.167(e)–1 and section 446 and the regulations thereunder.

§ 1.167(e) STATUTORY PROVISIONS; DEPRECIATION; CHANGE IN METHOD.

SEC. 167. DEPRECIATION. * * *

(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).

§ 1.167(e)–1 CHANGE IN METHOD.—(a) *In general.*—Any change in the method of computing the depreciation allowances with respect to a particular account is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that the change from the declining balance method to the straight line method as provided in section 167(e) shall be permitted without consent. See paragraph (b) below. A change in method of computing depreciation will be permitted only with respect to all the assets contained in a particular account as defined in § 1.167(a)–7. Any change in the percentage of the current straight line rate under the declining balance method, as for example, from 200% of the straight line rate to any other percent of the straight line rate, or any change in the interest factor used in connection with a compound interest or sinking fund method will constitute a change in method of depreciation and will require the consent of the Commissioner. Any request for a change in method of depreciation shall be made in accordance with section 446 and the regulations thereunder and shall state the character and location of the property, method of depreciation being used and the method proposed, the date of acquisition, the cost or other basis and adjustments thereto, amounts recovered through depreciation and other allowances, the estimated salvage

value, the estimated remaining life of the property, and such other information as may be required. For rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions, see section 381(c)(6) and the regulations thereunder.

(b) *Declining balance to straight line.*—In the case of an account to which the method described in section 167(b)(2) is applicable, a taxpayer may change without the consent of the Commissioner, from the declining balance method of depreciation to the straight line method at any time during the useful life of the property under the following conditions. Such a change may not be made if a provision prohibiting such a change is contained in an agreement under section 167(d). When the change is made, the unrecovered cost or other basis (less a reasonable estimate for salvage) shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. With respect to any account, this change will be permitted only if applied to all the assets in the account as defined in § 1.167(a)-7. The taxpayer shall furnish a statement with respect to the property which is the subject of the change showing the date of acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, the remaining useful life of the property, and such other information as may be required. The statement shall be attached to the taxpayer's return for the taxable year in which the change is made. A change to the straight line method must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

§ 1.167(f) STATUTORY PROVISIONS; DEPRECIATION; BASIS FOR DEPRECIATION.

SEC. 167. DEPRECIATION. * * *

(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.

§ 1.167(f)-1 BASIS FOR DEPRECIATION.—The basis upon which the allowance for depreciation is to be computed with respect to any property shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

§ 1.167(g) STATUTORY PROVISIONS; DEPRECIATION; LIFE TENANTS AND BENEFICIARIES OF TRUSTS AND ESTATES.

SEC. 167. DEPRECIATION. * * *

(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.

§ 1.167(g)-1 LIFE TENANTS AND BENEFICIARIES OF TRUSTS AND ESTATES.—(a) *Life tenants.*—In the case of property held by one person for life with remainder to another person, the deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(b) *Trusts.*—If property is held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(1) If under the trust instrument or local law the income of a trust computed without regard to depreciation is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(2) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depreciation deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation.

(c) *Estates.*—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 income of the estate which is allocable to each.

§ 1.167(h) STATUTORY PROVISIONS; DEPRECIATION; DEPRECIATION OF IMPROVEMENTS IN THE CASE OF MINES, ETC.

SEC. 167. DEPRECIATION. * * *

(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.

§ 1.167(h)-1 DEPRECIATION OF IMPROVEMENTS IN THE CASE OF MINES, ETC.—Property used in the trade or business or held for the production of income which is subject to the allowance for depreciation provided in section 611 shall be treated for all purposes of the Internal Revenue Code of 1954 as if it were property subject to the allowance for depreciation under section 167. The preceding sentence shall not limit the allowance for depreciation otherwise allowable under section 611.

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved June 7, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Filed by the Division of the Federal Register June 11, 1956, 8:51 a. m.)

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26 CFR 1.167(b)-0: Methods of computing depreciation. Rev. Rul. 56-256

Taxpayer, an individual, constructed a building and purchased equipment in 1954 upon which depreciation was computed on the declining balance method as prescribed in section 167(b)(2) of the Internal Revenue Code of 1954. In 1955, the taxpayer transferred the building and equipment to a newly formed corporation in a nontaxable exchange. *Held*, since the new corporation is a taxable entity separate from that of the individual taxpayer, it follows that the new corporation acquired property, the original use of which did not commence with it as required under section 167(c)(2) of the Code. Accordingly, under the limitations imposed by section 167(c) of the Code, the new corporation may not continue the use of the declining balance method of computing depreciation provided for in section 167(b)(2) of the Code; nor may it use the methods and rates of computing depreciation provided for in section 167(b)(3) of the Code, relating to the sum of the years-digits method, and section 167(b)(4) of the Code, relating to certain other consistent methods, with respect to the property. Depreciation on the building and equipment acquired by the corporation may be computed by using the straight line method or any other method, exclusive of those provided for in paragraphs (2), (3) and (4) of section 167(b) of the Code, which will, based upon existing operating conditions, produce a reasonable allowance therefor within the purview of section 167 of the Code. The above principle is equally applicable in cases where depreciable property is similarly transferred between other separate tax entities. However, see sections 381(a) and 381(c)(6) of the Code, relative to certain acquisitions of assets of a corporation by another corporation; and section 1.1502-46 of the Income Tax Regulations, relative to property received by a member of an affiliated group from another member of the group during a consolidated return period.

SECTION 169.—AMORTIZATION OF GRAIN-STORAGE FACILITIES

Rev. Rul. 56–226

A taxpayer, engaged in the business of breeding and selling hybrid seed corn, who furnishes seed corn to farmers for the purpose of producing such corn on land owned by the farmers at an agreed price per bushel or a guaranteed satisfactory return for the use of such land, is the producer and is entitled to the amortization deduction allowable under section 169(a)(1) of the Internal Revenue Code of 1954 on grain storage facilities constructed by him, provided he meets all the other requirements of section 169 of the Code.

Advice has been requested whether facilities constructed by a taxpayer to accommodate the storage of hybrid seed corn produced under certain types of contracts with farmers are amortizable under the provisions of section 169(a)(1) of the Internal Revenue Code of 1954.

The taxpayer is engaged principally in the business of breeding, developing, raising and selling hybrid corn for seed purposes. He entered into contracts with certain farmers under which the farmers, by using seed corn belonging to the taxpayer, agreed to grow corn for his use and sale. The farmers at no time own the seed corn nor can they produce its equivalent. The farmers are either guaranteed a satisfactory return for the use of their land and their efforts in certain experimental projects or are paid on an agreed basis per bushel for growing regular crops. They merely contract to perform services for the taxpayer. Facilities suitable primarily for the storage of grain were constructed by the taxpayer for storage of the seed corn produced.

Section 169 of the 1954 Code provides in part as follows:

(a) ALLOWANCE OF DEDUCTION.—

(1) * * * 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. * * *

* * * * * * *

(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 * * *

* * * * * * *

the construction, reconstruction, or erection of which was completed after December 31, 1952, and on or before December 31, 1956. * * *

In the case of any structure as described above, the taxpayer at the time of his election to take the amortization deduction with respect to the structure must intend to use the facility for the storage of grain produced or to be produced by him. See section 39.124B–2(b) of Regulations 118, as amended by T. D. 6112, C. B. 1954–2, 184, at 187, applicable to section 169 of the 1954 Code pursuant to T. D. 6091, C. B. 1954–2, 47. The deduction for amortization of grain-storage facilities is allowable not only to individuals but also to corporations, partnerships, estates and trusts.

In the instant case, the taxpayer at all times was the owner of the parent hybrid seed corn, the plants produced by the parent corn, and

the corn produced by such plants. The seed corn is grown under definite instructions and rules of the taxpayer; in fact, he shares certain expenses connected with the growing of it. The farmer may not use the corn for seeding purposes, he may not sell the seed corn; and he may not permit any other person to use for seed any of the crop produced from the parent seed corn supplied by the taxpayer.

Accordingly, it is held that the taxpayer is a producer of seed corn and the facilities constructed by him are grain-storage facilities with respect to which the amortization deduction provided by section 169 (a) (1) of the 1954 Code is allowable, provided all the other requirements of such section are met.

SECTION 170.—CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS

Rev. Rul. 56-262

An organization whose activities are educational, religious, or charitable, in the broad sense of those words, and which, as a secondary or incidental activity, also maintains an educational institution in the nature of a school, or a church or association of churches, or a hospital, does not qualify under the classes of organizations set forth under section 170(b)(1)(A) of the Internal Revenue Code of 1954, and contributions thereto will qualify as a deduction only to the extent of the general limitation of 20 percent of adjusted gross income provided by section 170(b)(1)(B) of the Code.

Rev. Rul. 55-219, C. B. 1955-1, 28, revoked.

Advice has been requested whether contributions to an organization whose activities are educational, religious, or charitable, in the broad sense of those words, and which, as a secondary or incidental activity, also maintains an educational institution in the nature of a school, or a church, or a hospital, will qualify for the deduction of ten percent of adjusted gross income provided by the special rule under section 170(b)(1)(A) of the Internal Revenue Code of 1954, in addition to the general limitation of 20 percent of adjusted gross income provided under section 170(b)(1)(B) of the Code.

In one instance, an organization has been incorporated for the primary purpose of engaging in research into the cause, origin, prevention, and cure of certain diseases. It also provides advanced instruction and training of personnel seeking to become qualified to engage in effective research operations in this field. Two general groups of students are maintained, namely, research specialists of professional rank and graduate students seeking the degree of Doctor of Philosophy in science. Research specialists attend lectures and seminars which provide the opportunity for acquiring knowledge and techniques relating to the research and the experimental treatment of certain diseases. The graduate student program is carried out under an agreement with a medical college whereby the facilities of the research organization are made available to certain graduate medical students of the college. Formal instruction taken by such students, who may or may not be employees of the research organization, is deemed to be work done "in residence" at the medical college. The income of the organization is derived from grants by the Federal government, private foundations, contracts with the Federal govern-

ment, contributions, bequests, etc. The organization has been held to be exempt from Federal income taxation under the provisions of section 501(c)(3) of the 1954 Code (section 101(6) of the 1939 Code).

In another instance, an organization is incorporated for the purpose of providing religious, educational, and industrial welfare for the poor and neglected. In this respect, a church sanctuary is maintained, where services are conducted three times a week. Vocational instruction is provided for the mentally retarded and children with a low intelligence quotient. A feature of the organization is the medical services for handicapped persons, provided through a rehabilitation center where patients, referred by medical doctors, are treated according to the course of treatment prescribed by the doctor. The organization has been held to be exempt from Federal income taxation under the provisions of section 501(c)(3) of the Code (section 101(6) of the 1939 Code).

Section 170(a)(1) of the Code provides that there shall be allowed as a deduction any charitable contribution payment of which is made within the taxable year.

Section 170(b)(1)(B) of the Code provides the general limitation, for deductions for charitable contributions by individuals, of 20 percent of adjusted gross income computed without regard to any net operating loss carryback to the taxable year under section 172 of the Code.

Under section 170(b)(1)(A) of the Code, individuals are allowed an additional deduction under a special rule whereby any charitable contribution to a church, or a convention or association of churches, an educational organization referred to in section 503(b)(2) of the Code, or a hospital referred to in section 503(b)(5) of the Code, shall be allowed to the extent that the aggregate of such additional contributions does not exceed ten percent of the taxpayer's adjusted gross income computed without regard to any net operating loss carryback to the taxable year under section 172 of the Code.

Section 503(b)(2) and (5), referred to in section 170(b)(1)(A) of the Code, reads as follows:

> (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;
>
> * * * * * * *
>
> (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.

In discussing section 170(b)(1)(A) of the 1954 Code, the Committee on Finance, United States Senate, said "this extra 10-per-cent deduction for charitable contributions is to be available with respect to any contributions to the specified types of organizations, even though contributions to other organizations account for the full amount allowable under the regular 20-percent limitation. This amendment is designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rates of return they are receiving on endowment funds." Report of the Committee on Finance, United States Senate, Report No. 1622, page 29. A similar statement is made by the Committee on Ways and Means, House of Representatives, House Report No. 1337, page 25.

An organization, which has educational activities in the broad sense of the word and which, incidental to its primary functions, regularly maintains a faculty and a curriculum and regularly has students in attendance at the place where its educational activities are conducted, is not an "educational organization" referred to in section 170(b)(1)(A)(ii) of the Code. Only those "educational organizations" organized primarily for, and engaged in, the presentation of formal education in the instructive sense constitute "educational organizations" within the meaning of section 170(b)(1)(A)(ii) of the Code.

Similarly, an organization, whose activities include the conducting of religious services and/or the ministration to the sick or mentally retarded, may have characteristics of a church and a hospital, and an educational institution, but where the principal purpose or function of such an organization is not that of a church or association of churches, or an educational organization, or a hospital, it will not qualify under any of the classes of organizations set forth in section 170(b)(1)(A)(i), (ii) or (iii) of the Code.

Accordingly, it is held that contributions to organizations whose activities are educational, religious, or charitable, in the broad sense of those words, and which, as a secondary or incidental activity, also maintain an educational institution in the nature of a school, or a church or association of churches, or a hospital, will qualify as a deduction only to the extent of the general limitation of 20 percent of adjusted gross income as provided by section 170(b)(1)(B) of the Code.

Revenue Ruling 55-219, C. B. 1955-1, 28, which holds that a museum, which is a corporation maintaining a regular faculty and curriculum with a regularly enrolled body of pupils, is an educational organization within the meaning of section 170(b)(1)(A)(ii) of the Code, and that contributions thereto by individuals are deductible in computing taxable income not only to the extent of the general limitation of 20 percent of adjusted gross income under section 170(b)(1)(B) of the Code, but also to the extent of the special limitation of ten percent of adjusted gross income under section 170(b)(1)(A) of the Code, is hereby revoked. However, under the authority of section 7805(b) of the Code, this ruling shall not be applied retroactively with respect to any contributions made by an individual prior to June 18, 1956, the date of this Bulletin.

Amounts paid for admission to a motion picture exhibition, as a part of a campaign to raise funds for an organization operated exclusively for charitable purposes. See Rev. Rul. 56-120, page 514.

Salary of a Member of Congress, a portion of which is returned to the United States Treasury. See Rev. Rul. 56-126, page 56.

Deductibility of contributions to a trust organized and operated for the primary purpose of paying pensions to retired employees of the employer which established the trust. See Rev. Rul. 56-138, page 202.

SECTION 172.—NET OPERATING LOSS DEDUCTION

(Also Part II, Sections 23(s), 122; Regulations 118, Section 39.122–4.) Rev. Rul. 56–285

The net operating loss for a taxable year, carried over and claimed as a deduction from income for a subsequent taxable year, should be adjusted to reflect the amount of depreciation properly allowable for the loss year, even though the statutory period of limitation for assessment of income tax for that year has expired.

Advice has been requested whether the net operating loss reported for the year 1950, by reason of which a net operating loss carryover is claimed as a deduction from income for the year 1955, should be adjusted by the amount of excessive depreciation claimed for the year 1950, since the statutory period of limitation for assessment of taxes for that year has expired.

Taxpayer was incorporated in June, 1950, and files its income tax returns on the calendar year basis. Each of the returns so filed for the years 1950 to 1954, inclusive, has shown a net loss. In its return for 1950, the corporation deducted depreciation computed on certain assets acquired at the time of its organization in 1950. It has been determined that the claimed basis of the assets was exessive, and hence that the amount of depreciation claimed as a deduction in the computation of the corporation's net operating loss for 1950 was also excessive.

Under section 122(b)(2)(B) of the Internal Revenue Code of 1939, as continued in effect by section 172(g)(1) of the Internal Revenue Code of 1954, a net operating loss sustained in a taxable year beginning after December 31, 1949, may be carried over to the five succeeding taxable years. The term "net operating loss" as defined in section 122(a) of the 1939 Code, with exceptions not here material, means the excess of the deductions allowed by Chapter 1 of that Code over the gross income. Among such deductions is the depreciation allowable under section 23(l). Under section 172 (a) and (e) of the 1954 Code, such net loss is allowable as a deduction in computing taxable income.

The fact that the statutory period for assessment of income taxes for the year in which the loss was sustained has expired does not preclude the making of such adjustments as may be necessary to correct the net operating loss deduction. *Phoenix Coal Co., Inc.* v. *Commissioner*, decided March 13, 1956, by the United States Court of Appeals for the Second Circuit. Therefore, it is held that the net operating loss for the year 1950, carried over and claimed as a deduction from income for the year 1955, should be adjusted to reflect the amount of depreciation properly allowable for the loss year. Compare *Commissioner* v. *William D. Disston*, 325 U. S. 442.

PART VII.—ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS

SECTION 213.—MEDICAL, DENTAL, ETC., EXPENSES

Rev. Rul. 56–18

The taxpayer has several hospitalization insurance policies which cover indemnification for hospital and doctors' bills but do not cover indemnification for nursing fees. Amounts received by the taxpayer as indemnification for hospital and doctors' fees exceeded his expenditures for these items. *Held*, in computing the deduction for medical expense allowable under section 213 of the Internal Revenue Code of 1954, the aggregate amounts expended by a taxpayer for medical care must be reduced by aggregate indemnities received under the hospitalization insurance policies, in arriving at the net deductible medical expense, which is subject to the limitation provided by section 213 of the Code, irrespective of the fact that such policies do not provide indemnification for certain of the medical expenditures.

Rev. Rul. 56–19

Amounts expended by a taxpayer to purchase bottled distilled water for drinking purposes, merely to avoid drinking the fluorinated water supplied by the city in which he lives, do not represent amounts paid for medical care within the meaning of section 213 of the Internal Revenue Code of 1954 and are not deductible for Federal income tax purposes.

(Also Section 262.) Rev. Rul. 56–263

Payments made for a "personal analysis" of students who are attending approved psychoanalytic training institutions, where such an analysis is required as part of their training in the theory and technique of psychoanalysis in preparation for practice as a psychoanalyst, do not constitute an allowable medical expense deduction under section 213 of the Internal Revenue Code of 1954, irrespective of whether such an analysis was given at the school or by a psychoanalyst not connected with the school. The cost of the personal analysis under such circumstances represents nondeductible personal expenses. Compare Rev. Rul. 143, C. B. 1953–2, 129.

SECTION 214.—EXPENSES FOR CARE OF CERTAIN DEPENDENTS

Rev. Rul. 56–169

The expenses for care of a child incurred by a taxpayer and paid during the taxable year for the purpose of enabling her to pursue certain educational or training courses, do not qualify as expenses paid for the care of a dependent within the meaning of section 214 of the Internal Revenue Code of 1954 and do not constitute an allowable deduction for Federal income tax purposes.

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Advice has been requested whether the expenses for child care paid during the taxable year by a taxpayer, for the purpose of enabling her to pursue certain educational courses or studies, qualify as deductible expenses within the meaning of section 214 of the Internal Revenue Code of 1954.

Section 214 of the Code provides in part as follows:

(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.

* * * * * * *

The term "gainfully employed" has been interpreted as also including active search for gainful employment. See Senate Report No. 1622, 83d Congress, 220, at page 221. The restriction of the statute to "gainful employment" necessarily precludes other activities engaged in by a taxpayer. Accordingly, it follows that the child care expenses paid by a taxpayer, for the purpose of enabling her to continue her studies or education, do not qualify as deductible expenses within the purview of section 214 of the Code.

PART VIII.—SPECIAL DEDUCTIONS FOR CORPORATIONS

SECTION 241.—ALLOWANCE OF SPECIAL DEDUCTIONS

26 CFR 1.241: Statutory provisions; allowance of special deductions. T. D. 6183[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Regulations with respect to sections 241 through 248 of the Internal Revenue Code of 1954.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On April 20, 1955, notice of proposed rulemaking regarding the regulations for taxable years beginning after December 31, 1953, and ending after August 16, 1954, except where otherwise provided therein, under sections 241 through 248 of the Internal Revenue Code of 1954, was published in the Federal Register (20 F. R. 2618). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the following regulations, which supersede paragraph (7) of Treasury Decision 6118, approved December 30, 1954 [C. B. 1955-1, 698], are hereby adopted:

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[1] 21 F. R. 4075.

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AUTHORITY: §§ 1.241 to 1.248–1, incl., issued under secs. 247, 248, 7805, I. R. C. 1954; 68A Stat. 75, 76, 917; 26 U. S. C. 247, 248, 7805.

SPECIAL DEDUCTIONS FOR CORPORATIONS

§ 1.241 STATUTORY PROVISIONS: ALLOWANCE OF SPECIAL DEDUCTIONS.

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.

§ 1.241–1 ALLOWANCE OF SPECIAL DEDUCTIONS.—A corporation, in computing its taxable income, is allowed as deductions the items specified in part VIII of subchapter B of chapter 1 (sections 242 through 248) in addition to the deductions provided in part VI (section 161 and following).

§ 1.242 STATUTORY PROVISIONS: PARTIALLY TAX-EXEMPT INTEREST.

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.

§ 1.242–1 DEDUCTION FOR PARTIALLY TAX-EXEMPT INTEREST.—A corporation is allowed a deduction under section 242(a) in an amount equal to certain interest received on obligations of the United States, or on obligations of corporations organized under Acts of Congress which are instrumentalities of the United States. The interest for

which a deduction shall be allowed is interest which is included in gross income and which is exempt from normal tax under the Act, as amended and supplemented, which authorized the issuance of the obligations.

§ 1.243 STATUTORY PROVISIONS; DIVIDENDS RECEIVED BY CORPORATIONS.

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.

§ 1.243–1 DEDUCTION FOR DIVIDENDS RECEIVED BY CORPORATIONS.—(a) A corporation is allowed a deduction under section 243(a) for dividends received from a domestic corporation which is subject to taxation under chapter 1 of the Internal Revenue Code. The deduction for a taxable year, except as provided in subsection (b) of section 243 and in section 246, is an amount equal to 85 percent of such dividends received by the corporation during the taxable year. To determine the amount of the distribution to a recipient corporation and the amount of the dividend, see § 1.301–1 and § 1.316–1.

(b) The deduction allowed by section 243 shall be determined without regard to any dividends described in paragraph (1) of section 244 (relating to dividends on the preferred stock of a public utility). That is, such deduction shall be determined without regard to any dividends received on the preferred stock of a public utility which is subject to taxation under chapter 1 of the Internal Revenue Code and with respect to which a deduction is allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities). For a deduction with respect to such dividends received on the preferred stock of a public utility, see section 244. If a deduction for dividends paid is not allowable to the distributing corporation under section 247 with respect to the dividends on its preferred stock, such dividends received from a domestic public utility corporation subject to taxation under chapter 1 of the Internal Revenue Code are includible in determining the deduction allowed by section 243(a).

(c) For limitation of dividends received deduction, see section 246 and the regulations thereunder.

§ 1.243–2 SPECIAL RULES FOR CERTAIN DISTRIBUTIONS.—(a) *Dividends paid by mutual savings banks, etc.*—In determining the deduction provided in section 243(a), any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, cooperative banks, and domestic building and loan associations) shall not be considered as a dividend.

(b) *Dividends received from regulated investment companies.*—In determining the deduction provided in section 243(a), dividends

received from a regulated investment company shall be subject to the limitations provided in section 854.

§ 1.244 STATUTORY PROVISIONS: DIVIDENDS RECEIVED ON CERTAIN PREFERRED STOCK.

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).

§ 1.244–1 DEDUCTION FOR DIVIDENDS RECEIVED ON CERTAIN PREFERRED STOCK.—A corporation is allowed a deduction under section 244 for dividends received on certain preferred stock of certain public utility corporations subject to taxation under chapter 1 of the Internal Revenue Code. The deduction is allowable only for dividends received on the preferred stock of a public utility with respect to which the deduction for dividends paid provided in section 247 (relating to dividends paid on certain preferred stock of public utilities) is allowable to the distributing corporation.

§ 1.244–2 COMPUTATION OF DEDUCTION.—(a) Section 244 provides a specific rule for the computation of the deduction for dividends received on the preferred stock of a public utility. The deduction computed under section 244 is subject to the limitation provided in section 246.

(b) The computation of the deduction provided in section 244 may be illustrated by the following examples:

Example (1). Corporation A, which files its income tax returns on the calendar year basis, received in 1954 $100,000 as dividends on the preferred stock of Corporation B, a public utility corporation which is subject to taxation under chapter 1 of the Internal Revenue Code. The deduction provided in section 247 is allowable to Corporation B, the distributing corporation, with respect to these dividends. The corporation normal tax rate and the surtax rate for the calendar year 1954 are 30 percent and 22 percent, respectively. The deduction allowable to Corporation A under section 244 for the year 1954 with respect to these dividends is $62,115.38, computed as follows:

Dividends received on preferred stock of Corporation B	$100,000.00
Less: The fraction specified in section 244(2) $\frac{14}{52} \times \$100,000$	26,923.08
Amount subject to 85 percent deduction	$73,076.92
Deduction—85 percent of $73,076.92	$62,115.38

Example (2). Assume the facts are the same as in example (1) except that the year involved is a taxable year for which the corporation normal tax rate and the surtax rate are 25 percent and 22 percent, respectively. The deduction allowable to Corporation A under section 244 for that taxable year is $59,680.85, computed as follows:

Dividends received on preferred stock of Corporation B	$100,000.00
Less: The fraction specified in section 244(2) $\frac{14}{47} \times \$100,000$	29,787.23
Amount subject to 85 percent deduction	$70,212.77
Deduction—85 percent of $70,212.77	$59,680.85

§ 1.245 STATUTORY PROVISIONS; DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.

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 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.

§ 1.245-1 DEDUCTION FOR DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.—(a) A corporation is allowed a deduction under section 245 for dividends received from a foreign corporation (other than a foreign personal holding company as defined in section 552) which is subject to taxation under chapter 1 of the Internal Revenue Code if, for an uninterrupted period of not less than 36 months ending with the close of the foreign corporation's taxable year in which the dividends are paid, such foreign corporation has been 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. If the foreign corporation has been in existence less than 36

months as of the close of the taxable year in which the dividends are paid, then the applicable uninterrupted period to be taken into consideration in lieu of the uninterrupted period of 36 or more months is the entire period such corporation has been in existence as of the close of such taxable year. An uninterrupted period which satisfies the twofold requirement with respect to business activity and gross income may start at a date later than the date on which the foreign corporation first commenced an uninterrupted period of engaging in trade or business within the United States, but the applicable uninterrupted period is in any event the longest uninterrupted period which satisfies such twofold requirement.

(b) The deduction provided in section 245 for a taxable year, except as provided in section 246, is the sum of the amounts computed under paragraphs (1) and (2) of section 245.

(c) The determination of earnings and profits distributed in any taxable year shall be made in accordance with the principles of section 316(a). For the determination of the source of income, see part I of subchapter N of chapter 1 (sections 861 through 864) and the regulations thereunder.

(d) The application of section 245 may be illustrated by the following examples:

Example (1). Corporation A (a foreign corporation filing its income tax returns on a calendar year basis) whose stock is 100 percent owned by Corporation B (a domestic corporation filing its income tax returns on a calendar year basis) for the first time engaged in trade or business within the United States on January 1, 1943, and qualifies under section 245 for the entire period beginning on that date and ending on December 31, 1954. Corporation A had accumulated earnings and profits of $50,000 immediately prior to January 1, 1943, and had earnings and profits of $10,000 for each taxable year during the uninterrupted period from January 1, 1943, through December 31, 1954. It derived for the period from January 1, 1943, through December 31, 1953, 90 percent of its gross income from sources within the United States and in 1954 derived 95 percent of its gross income from sources within the United States. During the calendar years 1943, 1944, 1945, 1946, and 1947 Corporation A distributed in each year $15,000; during the calendar years 1948, 1949, 1950, 1951, 1952, and 1953 it distributed in each year $5,000; and during the year 1954, $50,000. An analysis of the accumulated earnings and profits under the above statement of facts discloses that at December 31, 1953, the accumulation amounted to $55,000, of which $25,000 was accumulated prior to the "uninterrupted period" and $30,000 was accumulated during the uninterrupted period. (See section 316(a) and paragraph (c) of this section.) For 1954 a deduction under section 245 of $31,025 ($8,075 on 1954 earnings of the foreign corporation, plus $22,950 from the $30,000 accumulation at December 31, 1953) for dividends received from a foreign corporation is allowable to Corporation B with respect to the $50,000 received from Corporation A, computed as follows:

(i) $8,075, which is $8,500 (85 percent—the percent specified in section 243 for the calendar year 1954—of the $10,000 of earnings and profits of

the taxable year) multiplied by 95 percent (the portion of the gross income of Corporation A derived during the taxable year 1954 from sources within the United States), plus

(ii) $22,950 which is $25,500 (85 percent—the percent specified in section 243 for the calendar year 1954—of $30,000, the part of the earnings and profits accumulated after the beginning of the uninterrupted period) multiplied by 90 percent (the portion of the gross income of Corporation A derived from sources within the United States during that portion of the uninterrupted period ending at the beginning of the taxable year 1954).

Example (2). If in example (1), Corporation A for the taxable year 1954 had incurred a deficit of $10,000 (shown to have been incurred before December 31) the amount of the earnings and profits accumulated after the beginning of the uninterrupted period would be $20,000. If Corporation A had distributed $50,000 on December 31, 1954, the deduction under section 245 for dividends received from a foreign corporation allowable to Corporation B for 1954 would be $15,300, computed by multiplying $17,000 (85 percent—the percent specified in section 243 for the calendar year 1954—of $20,000 earnings and profits accumulated after the beginning of the uninterrupted period) by 90 percent (the portion of the gross income of Corporation A derived from United States sources during that portion of the uninterrupted period ending at the beginning of the taxable year 1954).

§ 1.246 STATUTORY PROVISIONS; RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

SEC. 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

(a) DEDUCTIONS 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, 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).

§ 1.246–1 DEDUCTIONS NOT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS.—The deductions provided in sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations) are not allowable with respect to any dividend received from—

(a) A corporation organized under the China Trade Act, 1922 (15 U. S. C. ch. 4) (see section 941); or

(b) A corporation which is exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations) for the taxable year of the corporation in which the distribution is made or for its next preceding taxable year; or

(c) A corporation to which section 931 (relating to income from sources within possessions of the United States) applies for the taxable year of the corporation in which the distribution is made or for its next preceding taxable year.

§ 1.246–2 LIMITATION ON AGGREGATE AMOUNT OF DEDUCTIONS.—(a) *General rule.*—The sum of the deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations), except as provided in section 246(b)(2) and in paragraph (b) of this section, is limited to 85 percent of the taxable income of the corporation. The taxable income of the corporation for this purpose is computed without regard to the net operating loss deduction allowed by section 172, the deduction for dividends paid on certain preferred stock of public utilities allowed by section 247, and the deductions provided in sections 243, 244, and 245. For definition of the term "taxable income", see section 63.

(b) *Effect of net operating loss.*—If the shareholder corporation has a net operating loss (as determined under section 172) for a taxable year, the limitation provided in section 246(b)(1) and in paragraph (a) of this section is not applicable for such taxable year. In that event, the deductions provided in sections 243, 244, and 245 shall be allowable for all tax purposes to the shareholder corporation for such taxable year without regard to such limitations. If the shareholder corporation does not have a net operating loss for the taxable year, however, the limitation will be applicable for all tax purposes for such taxable year. In determining whether the shareholder corporation has a net operating loss for a taxable year under section 172, the deductions allowed by sections 243, 244, and 245 are to be computed without regard to the limitation provided in section 246(b)(1) and in paragraph (a) of this section.

§ 1.247 STATUTORY PROVISIONS; DIVIDENDS PAID ON CERTAIN PREFERRED STOCK OF PUBLIC UTILITIES.

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 cur-

rent 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.

§ 1.247–1 DEDUCTION FOR DIVIDENDS PAID ON PREFERRED STOCK OF PUBLIC UTILITIES.—(a) *Amount of deduction.*—(1) A deduction is provided in section 247 for dividends paid during the taxable year by certain public utility corporations (see paragraph (b) of this section) on certain preferred stock (see paragraph (c) of this section). This reduction is an amount equal to the product of a specified fraction times the lesser of (i) the amount of the dividends paid during the taxable year by a public utility on its preferred stock (as defined in paragraph (c) of this section), or (ii) the taxable income of the public utility for such taxable year (computed without regard to the deduction allowed by section 247). The specified fraction for any taxable year is the fraction the numerator of which is 14 and the denominator of which is the sum of the corporation normal tax rate and the surtax rate for such taxable year specified in section 11. Since section 11 provides that for the calendar year 1954 the corporation normal tax rate is 30 percent and the surtax rate is 22 percent, the sum of the two tax rates is 52 percent and the specified fraction for the calendar year 1954 is 14/52. If, for example, section 11 should specify that the corporation's normal tax rate is 25 percent and the surtax rate is 22 percent for the calendar year, the sum of the two tax rates will be 47 percent and the specified fraction for the calendar year will

be 14/47. If Corporation A, a public utility which files its income tax return on the calendar year basis, pays $100,000 dividends on its preferred stock in the calendar year 1954 and if its taxable income for such year is greater than $100,000 the deduction allowable to Corporation A under section 247 for 1954 is $100,000 times 14/52, or $26,923.08. If in 1954 Corporation A's taxable income, computed without regard to the deduction provided in section 247, had been $90,000 (that is, less than the amount of the dividends which it paid on its preferred stock in that year), the deduction allowable under section 247 for 1954 would have been $90,000 times 14/52, or $24,230.77.

(2) For the purpose of determining the amount of the deduction provided in section 247(a) and in subparagraph (1) of this paragraph, the amount of dividends paid in a given taxable year shall not include any amount distributed in such year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. If any distribution is made in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year, such distribution will be deemed to have been made with respect to the earliest year or years for which there are dividends unpaid and accumulated. Thus, if a public utility makes a distribution with respect to a prior taxable year, it shall be considered that such distribution was made with respect to the earliest year or years for which there are dividends unpaid and accumulated, whether or not the public utility states that the distribution was made with respect to such year or years and even though the public utility states that the distribution was made with respect to a later year. Even though it has dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may, however, include the dividends paid with respect to the current taxable year in computing the deduction under section 247. If there are no dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may include the dividends paid with respect to a prior taxable year which ended after October 1, 1942, in computing the deduction under section 247; such public utility in addition may include the dividends paid with respect to the current taxable year in computing the deduction under section 247. However, if local law or its own charter requires a public utility to pay all unpaid and accumulated dividends before any dividends can be paid with respect to the current taxable year, such public utility may not include any distribution in the current year in computing the deduction under section 247 to the extent that there are dividends unpaid and accumulated with respect to taxable years ending before October 1, 1942.

(3) If a corporation which is engaged in one or more of the four types of business activities (herein called utility activities) enumerated in section 247(b)(1) (the furnishing of telephone service or the sale of electrical energy, gas, or water) is also engaged in some other business that does not fall within any of the enumerated categories, the deduction under section 247 is allowable only for such portion of the amount computed under section 247(a) as is allocable to the income from utility activities. For this purpose, the allocation may be made on the basis of the ratio which the total income from the utility activities bears to total income from all sources (total income being considered either gross income or gross receipts, whichever method results in the higher deduction). However, if such an allocation reaches an

inequitable result and the books of the corporation are so kept that the taxable income attributable to the utility activities can be readily determined, particularly where the books of the corporation are required by governmental bodies to be so kept for rate making or other purposes, the allocation may be made upon the basis of taxable income. No such apportionment will be required if the income from sources other than utility activities is less than 20 percent of the total income of the corporation, irrespective of the method used in determining such total income.

(b) *Public utility.*—As used in section 247 and this section, public utility means a corporation engaged in the furnishing of telephone service, or in the sale of electric energy, gas, or water if the rates charged by such corporation 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. If a schedule of rates has been filed with any of the above bodies having the power to disapprove such rates, then such rates shall be considered as established or approved rates even though such body has taken no action on the filed schedule. Rates fixed by contract between the corporation and the purchaser, except where the purchaser is the United States, a State, the District of Columbia, or an agency or political subdivision of the United States, a State, or the District of Columbia, shall not be considered as established or approved rates in those cases where they are not subject to direct control, or where no maximum rate for such contract rates has been established by the United States, a State, the District of Columbia, or by an agency or political subdivision thereof. The deduction provided in section 247 will not be denied solely because part of the gross income of the corporation consists of revenue derived from such furnishing or sale at rates which are not so regulated, provided the corporation establishes to the satisfaction of the Commissioner (1) that the revenue from regulated rates and the revenue from unregulated rates are derived from the operation of a single interconnected and coordinated system within a single area or region in one or more States, or from the operation of more than one such system and (2) that the regulation to which it is subject in part of its operating territory in one such system is effective to control rates within the unregulated territory of the same system so that the rates within the unregulated territory have been and are substantially as favorable to users and consumers as are the rates within the regulated territory.

(c) *Preferred stock.*—(1) For the purposes of section 247 and this section, preferred stock means stock (i) which was issued before October 1, 1942, (ii) the dividends in respect of which (during the whole of the taxable year, or the part of the taxable year after the actual date of the issue of such stock) were cumulative, nonparticipating as to current distributions, and payable in preference to the payment of dividends on other stock, and (iii) the rate of return on which is fixed and cannot be changed by a vote of the board of directors or by some similar method. However, if there are several classes of preferred stock, all of which meet the above requirements, the deduction provided in section 247 shall not be denied in the case

of a given class of preferred stock merely because there is another class of preferred stock whose dividends are to be paid before those of the given class of stock. Likewise, it is immaterial for the purposes of section 247 and this section whether the stock be voting or nonvoting stock.

(2) Preferred stock issued on or after October 1, 1942, under certain circumstances will be considered as having been issued before October 1, 1942, for purposes of the deduction provided in section 247. If the new stock is issued on or after October 1, 1942, to refund or replace bonds or debentures which were issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), such new stock shall be considered as having been issued before October 1, 1942. If preferred stock is issued to refund or replace stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), it shall be immaterial whether the preferred stock so refunded or replaced was issued before, on, or after October 1, 1942. If stock issued on or after October 1, 1942, to refund or replace stock which was issued before October 1, 1942, and which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), is not itself preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), no stock issued to refund or replace such stock can be considered preferred stock for purposes of the deduction provided in section 247.

(3) In the case of any preferred stock issued on or after October 1, 1942, to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), only that portion of the stock issued on or after October 1, 1942, will be considered as having been issued before October 1, 1942, the par or stated value of which does not exceed the par, stated, or face value of such bonds, debentures, or other preferred stock which the new stock was issued to refund or replace. In such case no shares of the new stock issued on or after October 1, 1942, shall be earmarked in determining the deduction allowable under section 247, but the appropriate allocable portion of the total amound of dividends paid on such stock will be considered as having been paid on stock which was issued before October 1, 1942.

(4) The provisions of section 247 (b)(2) may be illustrated by the following example:

Example. A public utility has outstanding 1,000 bonds which were issued before October 1, 1942, and each of which has a face value of $100. On or after October 1, 1942, each of such bonds is retired in exchange for $1\frac{1}{10}$ shares of preferred stock issued on or after October 1, 1942, and having a par value of $100 per share. Only $\frac{10}{11}$ of the dividends paid on the preferred stock thus issued in exchange for the bonds will be considered as having been paid on stock which was issued before October 1, 1942. Likewise, if preferred stock which is issued on or after October 1, 1942, has no par value but a stated value of $50 per share and such stock

is issued in a ratio of three shares to one share to refund or replace preferred stock having a par value of $100 per share, only two-thirds of the dividends paid on the new shares of stock will be considered as having been paid on stock which was issued before October 1, 1942.

(5) Whether or not preferred stock issued on or after October 1, 1942, was issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, is in each case a question of fact. Among the factors to be considered is whether such stock is new in an economic sense to the corporation or whether it was issued merely to take the place, directly or indirectly, of bonds, debentures, or other preferred stock of such corporation. It is not necessary that the new preferred stock be issued in exchange for such bonds, debentures, or other preferred stock. The mere fact that the bonds, debentures, or other preferred stock remain in existence for a short period of time after the issuance of the new stock (or were retired before the issuance of the new stock) does not necessarily mean that such new stock was not issued to refund or replace such bonds, debentures, or other preferred stock. It is necessary to consider the entire transaction, including the issuance of the new preferred stock, the date of such issuance, the retirement of the old bonds, debentures, or preferred stock, and the date of such retirement, in order to determine whether such new stock really was issued to take the place of bonds, debentures, or other preferred stock of the corporation or whether it represents something essentially new in an economic sense in the corporation's financial structure. If, for example, a public utility, which has outstanding bonds issued before October 1, 1942, issues new preferred stock on October 1, 1954, in order to secure funds with which to retire such bonds and with the money paid in for such stock retires the bonds on November 1, 1954, such stock may be considered as having been issued to refund or replace bonds issued before October 1, 1942. Whether the money used to retire the bonds can be traced back and identified as the money paid in for the stock will have evidentiary value, but will not be conclusive, in determining whether the stock was issued to refund or replace the bonds. Similarly, whether the amount of money used to retire the bonds was smaller than, equal to, or greater than that paid in for the stock, or whether the entire issue of bonds is retired, will be important, but not decisive, in making such determination.

(6) Preferred stock issued on or after October 1, 1942, by a corporation to refund or replace bonds or debentures of a second corporation which were issued before October 1, 1942, or to refund or replace other preferred stock of such second corporation, may be considered as having been issued before October 1, 1942, if such new stock was issued (i) in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939; or (ii) in a transaction to which section 371 (relating to insolvency reorganizations), or the corresponding provisions of the Internal Revenue Code of 1939, is applicable; or (iii) in a transaction which is subject to the provisions of part VI of subchapter O (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission) or to the corresponding provisions of the Internal Revenue Code of 1939. Whether the stock

actually was issued to refund or replace bonds or debentures of the second corporation issued before October 1, 1942, or to refund or replace preferred stock of such second corporation, shall be determined under the same principles as if only one corporation were involved. A corporation may issue stock to refund or replace its own bonds, debentures, or other preferred stock in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939, in a transaction to which section 371 or the corresponding provisions of the Internal Revenue Code of 1939 is applicable, or in a transaction which is subject to the provisions of part VI of subchapter O or to the corresponding provisions of the Internal Revenue Code of 1939. The provisions of this paragraph, in addition, are applicable in case a corporation issues stock on or after October 1, 1942, to refund or replace its own bonds, debentures, or other preferred stock even though the issuance of such stock may not fall within one of the categories enumerated above.

(7) Even though stock issued on or after October 1, 1942, is considered as having been issued before October 1, 1942, by reason of having been issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, such stock will not be deemed to be preferred stock within the meaning of section 247(b)(2), and no deduction will be allowable in respect of dividends paid on such stock, unless the stock fulfills all the other requirements of a preferred stock set forth in section 247(b)(2) and in this paragraph.

§ 1.248 STATUTORY PROVISIONS; ORGANIZATIONAL EXPENDITURES.

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.

§ 1.248-1 ELECTION TO AMORTIZE ORGANIZATIONAL EXPENDITURES.—(a) *In general.*—(1) Section 248(a) provides that a corporation may elect for any taxable year beginning after December 31, 1953, to treat its organizational expenditures, as defined in subsection (b) of section 248 and in paragraph (b) of this section, as deferred expenses. A

corporation which exercises such election must, at the time it makes the election, select a period of not less than 60 months, beginning with the month in which it began business, over which it will amortize its organizational expenditures. The period selected by the corporation may be equal to or greater, but not less, than 60 months, but in any event it must begin with the month in which the corporation began business. The organizational expenditures of the corporation which are treated as deferred expenses under the provisions of section 248 and this section shall then be allowed as a deduction in computing taxable income ratably over the period selected by the taxpayer. The period selected by the taxpayer in making its selection may not be subsequently changed but shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

(2) If a corporation exercises the election provided in section 248(a), such election shall apply to all of its expenditures which are organizational expenditures within the meaning of subsection (b) of section 248 and paragraph (b) of this section. The election shall apply, however, only with respect to expenditures incurred before the end of the taxable year in which the corporation begins business (without regard to whether the corporation files its returns on the accrual or cash method of accounting or whether the expenditures are paid in the taxable year in which they are incurred), if such expenditures are paid or incurred on or after August 16, 1954 (the date of enactment of the Internal Revenue Code of 1954).

(3) The deduction allowed under section 248 must be spread over a period beginning with the month in which the corporation begins business. The determination of the date the corporation begins business presents a question of fact which must be determined in each case in light of all the circumstances of the particular case.

The words "begins business," however, do not have the same meaning as "in existence." Ordinarily, a corporation begins business when it starts the business operations for which it was organized; a corporation comes into existence on the date of its incorporation. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

(b) *Organizational expenditures defined.*—(1) Section 248(b) defines the term "organizational expenditures." Such expenditures, for purposes of section 248 and this section, are those expenditures which are directly incident to the creation of the corporation. An expenditure, in order to qualify as an organizational expenditure, must be (i) incident to the creation of the corporation, (ii) chargeable to the capital account of the corporation, and (iii) of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. An expenditure which fails to meet each of these three tests may not be considered an organizational expenditure for purposes of section 248 and this section.

(2) The following are examples of organizational expenditures within the meaning of section 248 and this section: legal services incident to the organization of the corporation, such as drafting the corporate charter, by-laws, minutes of organizational meetings, terms of original stock certificates, and the like; necessary accounting services; expenses of temporary directors and of organizational meetings of directors or stockholders; and fees paid to State of incorporation.

(3) The following expenditures are not organizational expenditures within the meaning of section 248 and this section:

(i) Expenditures connected with issuing or selling shares of stock or other securities, such as commissions, professional fees, and printing costs. This is so even where the particular issue of stock to which the expenditures relate is for a fixed term of years;

(ii) Expenditures connected with the transfer of assets to a corporation.

(4) Expenditures connected with the reorganization of a corporation, unless directly incident to the creation of a corporation, are not organizational expenditures within the meaning of section 248 and this section.

(c) *Time and manner of making election.*—The election provided by section 248(a) and paragraph (a) of this section shall be made in a statement attached to the taxpayer's return for the taxable year in which it begins business. Such taxable year must be one which begins after December 31, 1953. The return and statement must be filed not later than the date prescribed by law for filing the return (including any extensions of time) for the taxable year in which the taxpayer begins business. The statement shall set forth the description and amount of the expenditures involved, the date such expenditures were incurred, the month in which the corporation began business, and the number of months (not less than 60 and beginning with the month in which the taxpayer began business) over which such expenditures are to be deducted ratably.

O. Gordon Delk,
Acting Commissioner of Internal Revenue.

Approved June 8, 1956.

Dan Throop Smith,
Special Assistant to the Secretary in Charge of Tax Policy.

(Filed by the Division of the Federal Register June 13, 1956, 8:49 a. m.)

SECTION 243.—DIVIDENDS RECEIVED BY CORPORATIONS

Interest received on certain certificates of indebtedness issued by a mutual life insurance company. See Rev. Rul. 56–107, page 314.

Special deduction for dividends received where alternative tax is applicable. See Rev. Rul. 56–151, page 382.

SECTION 244.—DIVIDENDS RECEIVED ON CERTAIN PREFERRED STOCK

Special deduction for dividends received on certain preferred stock where alternative tax is applicable. See Rev. Rul. 56–151, page 382.

SECTION 245.—DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS

Special deduction for certain foreign dividends received where alternative tax is applicable. See Rev. Rul. 56–151, page 382.

SECTION 247.—DIVIDENDS PAID ON CERTAIN PREFERRED STOCK OF PUBLIC UTILITIES

Special deduction for certain dividends paid where alternative tax is applicable. See Rev. Rul. 56–151, page 382.

PART IX.—ITEMS NOT DEDUCTIBLE

SECTION 262.—PERSONAL, LIVING, AND FAMILY EXPENSES

(Also Section 162.) Rev. Rul. 56–25

The expenses incurred by an employee in using his automobile for commuting between his place of abode and his place of work (principal or regular post of duty or employment), regardless of the distance involved, represent nondeductible personal expenses within the purview of section 262 of the Internal Revenue Code of 1954, notwithstanding the fact that the automobile is also used to transport tools used by the employee in his work. The expenses so incurred in going to and from work were not increased by reason of the fact that the tools used by the employee in his work were also transported in the automobile. Thus, the entire amount of the expense is deemed to be commuting expense, no part thereof being allocable to the transporting of the tools. See *Conrad P. Stephan et ux.* v. *Commissioner*, Tax Court Memorandum Opinion, entered February 27, 1952. For the general and established principle that commuting expenses are not deductible, see section 39.23(a)–2(i) of Regulations 118, applicable to section 162 of the 1954 Code by virtue of Treasury Decision 6091, C. B. 1954–2, 47; S. M. 1048, C. B. No. 1, 101 (1919); I. T. 1184, C. B. I–1, 121 (1922); Rev. Rul. 54–497, C. B. 1954–2, 75, at page 81; and Rev. Rul. 55–555, C. B. 1955–2, 20.

Rev. Rul. 56–49

A fireman is not traveling away from home in the pursuit of his trade or business while performing services at his principal or regular post of duty, even though he works a 24-hour shift during which he must remain at the firehouse overnight and cannot leave his station for meals. The tax or business "home" of a fireman, as in the case of other

taxpayers, is held to be his principal or regular post of duty. See Revenue Ruling 54–497, C. B. 1954–2, 75. Furthermore, a fireman who is assigned on different days to different locations within the same city or general area is not "away from home," because a taxpayer's principal or regular post of duty is not limited to a particular building or property, but includes the entire city or general locality in which he customarily carries on his trade or business. See the sixth paragraph in Revenue Ruling 55–109, C. B. 1955–1, 261. Thus, the expenses incurred by a fireman for meals consumed at a firehouse under the circumstances referred to herein are not deductible as traveling or business expenses, but represent nondeductible living expenses. See *Jess H. Taylor et al.* v. *Commissioner*, Tax Court Memorandum Opinion entered June 24, 1952.

Expenses of business trips and of attending conventions of a taxpayer's related business group which are made for both personal and business reasons. See Rev. Rul. 56–168, page 93.

Costs incurred for "personal analysis" by students attending psychoanalytic training institutions. See Rev. Rul. 56–263, page 135.

SECTION 266.—CARRYING CHARGES

(Also Part II, Section 24(a); Regulations 118, Section 39.24(a)–6.) Rev. Rul. 56–264

> Insurance premiums paid or incurred by a taxpayer as the mortgagor on a mortgage loan, attributable to the loan during the period of construction of business improvements covered by the loan, represent trade or business expenses which are deductible under section 161 of the Internal Revenue Code of 1954. Such insurance premiums constitute carrying charges within the meaning of section 266 of the Code and, at the election of the taxpayer, may be capitalized. Where such election to capitalize is made, it is binding upon the taxpayer during the period of construction of the particular improvements covered by the loan. However, with respect to unimproved and unproductive real property, the election to capitalize taxes, interest and other carrying charges must be made for each taxable year for which the taxpayer desires to capitalize such items, each year constituting a separate election to be exercised by the filing of a timely return.

Advice has been requested as to (1) the deductibility of insurance premiums incurred by the mortgagor on a mortgage loan, attributable to the loan during the period of construction of improvements covered by the loan, and (2) the deductibility of taxes, interest and other carrying charges with respect to unimproved and unproductive real property.

In financing the construction of business improvements, the taxpayer borrowed money evidenced by a mortgage note secured by a mortgage deed. In order to protect the security of the mortgage, the mortgagee contracted for mortgage insurance calling for the payment of an annual premium. In the mortgage deed, the taxpayer, as mortgagor, covenanted to provide the mortgagee with funds to pay such premium. During the period of construction, the taxpayer

discharged his obligation under the covenant with respect to the mortgage insurance premiums attributable to such period. The taxpayer continued to make payments pursuant to such covenant after the construction was completed and the improvements were occupied, and the payments were deducted as ordinary business expenses.

Section 266 of the Internal Revenue Code of 1954 relating to carrying charges provides:

> 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.

Section 39.24(a)-6 of Regulations 118, applicable by virtue of Treasury Decision 6091, C. B. 1954-2, 47, provides that a taxpayer, at his election, may capitalize taxes and carrying charges with respect to the construction of improvements on real property, whether the property is productive or unproductive up to the time construction is completed, notwithstanding that such expenditures are expressly deductible under section 23 of the Code of 1939 (now section 161 of the Internal Revenue Code of 1954).

The term "carrying charges" as used in the regulations is not defined therein, but the illustrations given thereof, in connection with the construction of improvements on real property, refer to certain types of taxes thereon, interest on a loan made or continued to furnish funds for this purpose, "*and other necessary expenditures paid in connection therewith up to the time the development or construction work has been completed.*" Any item properly includible in the term "carrying charges" must consist of expenditures which essentially are deductible under section 161 of the Code, as distinguished from capital items under section 263 of the Code.

The insurance charges, with respect to the mortgage loan, incurred during the period of construction, being a deductible item under the provisions of section 161 of the Internal Revenue Code of 1954, come within the general concept of the term "carrying charges" as used in section 266 of the Code; and, at the election of the taxpayer, may be capitalized; but, once an election is properly made, it is binding on the taxpayer with respect to the particular project during the period of construction. In the case of unproductive and unimproved real property, the election to capitalize taxes, interest and other carrying charges may be exercised for a given year without regard to any election with respect to the same property made in a prior year. See section 39.24(a)-6(b)(3) of Regulations 118.

In each instance, the election must be exercised by filing with the original return, or a timely filed amended return, a statement showing the item or items the taxpayer elects to capitalize. There is no provision for an election to be made retroactively. Therefore, if a taxpayer files an original or amended return for a particular year prior to the due date without exercising an election to capitalize such charges, he may not, after the due date for filing the return, file an amended return for that year to reflect such election.

"Commitment fees" or "standby charges" capitalized as part of construction costs. See Rev. Rul. 56-136, page 92.

SECTION 267.—LOSSES, EXPENSES, AND INTEREST WITH RESPECT TO TRANSACTIONS BETWEEN RELATED TAXPAYERS

Rev. Rul. 56–222

Where certain stock owned by a decedent's estate is made the subject of a bona fide sale by the executor to an inter vivos trust which the decedent, as grantor, created for the benefit of his widow, any loss sustained on such sale does not constitute the type of loss disallowed by section 267(a) of the Internal Revenue Code of 1954. Such loss constitutes a capital loss and is deductible from the gross income of the estate to the extent provided in section 1211(b) of the Code.

SECTION 270.—LIMITATION OF DEDUCTIONS ALLOWABLE TO INDIVIDUALS IN CERTAIN CASES

Rev. Rul. 56–170

Where, under the provisions of section 263(c) of the Internal Revenue Code of 1954 or the corresponding provisions of prior revenue laws, the taxpayer has elected to deduct, rather than defer or capitalize, certain intangible drilling and development costs in the case of oil and gas wells, which election is binding for all subsequent years, such costs constitute specially treated deductions within the meaning of section 270(b) of the Code, notwithstanding the fact that an election is no longer permissible with respect to such costs paid or incurred in years subsequent to the year of election. Accordingly, such costs are to be disregarded in determining whether, under section 270 of the Code, relating to the limitation on deductions allowable to individuals in certain cases, the deductions of the taxpayer attributable to a trade or business carried on by him for five consecutive taxable years have, in each of such years (including at least one year to which Subtitle A of the Internal Revenue Code of 1954 relating to income taxes applies), exceeded by more than $50,000 the gross income derived from such trade or business.

SUBCHAPTER C.—CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

PART I.—DISTRIBUTIONS BY CORPORATIONS

SUBPART A.—EFFECTS ON RECIPIENTS

SECTION 301.—DISTRIBUTIONS OF PROPERTY

26 CFR 1.301–1: Rules applicable with respect to distributions of money and other property. Rev. Rul. 56–211

Where a taxpayer purchased cumulative preferred stock on which there were accumulated dividends, the total amount received during the current taxable year, which includes an amount representing the dividend payable for the year and an amount to be applied against the accumulated dividends, constitutes dividend income for the year in which received, no part of which may be applied to reduce the purchase price of the stock.

Advice has been requested as to the proper method of reporting, for Federal income tax purposes, payments received during a taxable year and applied against accumulated dividends on preferred stock.

In 1950 the taxpayer purchased a certain number of shares of cumulative preferred stock of a corporation at $170x$ dollars per share. At that time the accumulated dividends on the preferred stock were $150x$ dollars per share. In the taxable year 1954 the corporation paid the current dividend of $8x$ dollars per share on the preferred stock and $12x$ dollars on account of the accumulated dividends.

Section 301 of the Internal Revenue Code of 1954, relating to distributions of property, provides in part:

> (c) AMOUNT TAXABLE.— * * *
> (1) AMOUNT CONSTITUTING DIVIDEND.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

Section 316 of the Code provides in part:

> (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 diminuation 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.

Section 39.22(a)–1 of Regulations 118, made applicable to section 301 of the Internal Revenue Code of 1954 by Treasury Decision 6091, C. B. 1954–2, 47, provides that the amount paid by the purchaser of stock to the seller in contemplation of the next dividend payment is an investment of capital and may not be claimed as a deduction from gross income. In I. T. 2569, C. B. X–1, 101 (1931), it is stated that although the purchaser of stock may have every reason to expect the full amount of the regular dividend to be paid after the stock is purchased, the price paid for the stock is the cost of the stock to him.

The Internal Revenue Service has consistently held that dividends on stock do not accrue as interest accrues, but represent ordinary income to the stockholder of record when actually or constructively received by him, regardless of the period for which the dividends are paid. See *Julius S. Rippel et al.*, 12 B. T. A. 438, and *Marcus Frieder et al.*, 27 B. T. A. 1239. Compare *Estate of Henry W. Putnam* v. *Commissioner*, 324 U. S. 393, Ct. D. 1638, C. B. 1945, 345.

Accordingly, it is held that the entire $20x$ dollars per share shall be treated as dividend income in the year received, to the extent it was paid out of the corporation's earnings and profits as defined in section 316(a) of the Code.

(Also Sections 302, 316; 1.302–1, 1.316–1.) Rev. Rul. 56–265

> The redemption by a corporation of all outstanding preferred stock held by a stockholder, who also held all the outstanding common stock of the corporation, is essentially equivalent to the distribution of a dividend and is taxable as a distribution of property under sections 301 and 316 of the Internal Revenue Code of 1954.

Advice has been requested as to the tax consequences, under the circumstances described below, of the redemption by a corporation of its outstanding preferred stock.

The stock of *Y* corporation consisted of preferred and common, and such stock was owned by persons not related to *N*, a prospective buyer of the stock of *Y*. *O* corporation owned all the preferred and a portion of the common stock of *Y*.

N agreed to purchase all the outstanding common stock of *Y* corporation after *Y* corporation had redeemed the outstanding preferred stock at par value plus a premium of $10 a share.

Y corporation was advised by *O* corporation that under the charter provisions, in the event of redemption of the *Y* corporation preferred stock, the holder of such stock would have the right to elect to purchase at $10 per share one share of common stock of *Y* corporation in respect of each share of preferred stock called for redemption. It was explained that if the preferred stock were redeemed, *O* corporation would feel impelled to elect to exercise its right to buy an equal number of shares of common stock of *Y* corporation at $10 a share. The issuance of additional common stock by *Y* corporation to *O* corporation would dilute the equity of the other *Y* corporation common stockholders and the sale of their stock, at the price offered by *N* for all common stock of *Y* corporation, would not be attractive to them.

Thereupon, *N* purchased all the outstanding stock of *Y* corporation, both common and preferred, and *Y* corporation redeemed all its preferred stock then held by *N*.

Under the foregoing circumstances, it is held the cancellation or redemption by *Y* corporation of all its preferred stock is not to be treated as an exchange under section 302(a) of the Internal Revenue Code of 1954, the redemption being essentially equivalent to a dividend. The amount distributed is includible in the gross income of *N* to the extent the distribution is a dividend as provided by sections 301 and 316 of the Code.

A redemption of stock of certain shares of one corporation held by another corporation. See Rev. Rul. 56–182, below.

Dividends by a corporation to its shareholders. See Rev. Rul. 56–184, page 190.

A distribution of stock of a new corporation to shareholders of a corporation which had transferred some of its assets therefor. See Rev. Rul. 56–227, page 183.

The fair market value of the stock of a new corporation distributed to shareholders of the old corporation. See Rev. Rul. 56–266, page 184.

SECTION 302.—DISTRIBUTIONS IN REDEMPTION OF STOCK

26 CFR 1.302–1: General. Rev. Rul. 56–182
(Also Sections 301, 316; Sections 1.301–1, 1.316–1.)

Where a corporation purchased and retired certain shares of its stock held by a majority stockholder, who continued to be a majority

stockholder after the transaction, in order that one of its employees could acquire sufficient additional stock to increase his holdings to equal a one-third interest in the corporation, the distribution and redemption of the stock was essentially equivalent to a dividend. Such redemption under section 302(d) of the Internal Revenue Code of 1954 constitutes a distribution of property under section 301 of the Code and is taxable as a dividend to the extent provided in section 316 of the Code.

The Internal Revenue Service has been requested to state its position with respect to the redemption by a certain corporation of a part of its capital stock.

X is a corporation having 442 shares of capital stock outstanding. The stock is held by three individuals and *Y* corporation, *i. e.*, 1, 1, and 81 shares by *A*, *B*, and *C* (all individuals), respectively, and 359 shares by *Y* corporation. The stock of *Y* corporation is entirely owned by *A* and *B*. *C* is a key employee of *X* corporation and is in no way related to the shareholders of *Y* corporation.

At the time *X* corporation was incorporated, a stock purchasing agreement was entered into between *Y* corporation and *C* which provided that *C* could buy at his option up to one-third of the stock of *X* corporation, the price of the stock being set at book value at the time of purchase.

In order that *C* may acquire one-third of *X* stock, *Y* corporation sold to *C* nine shares of *X* corporation stock which increased his holdings to 90 shares. At the same time, *X* corporation purchased and retired 172 shares of its stock held by *Y* corporation. *A* and *B* each retained one share of *X* corporation stock. As a result of the above-described transactions, *Y* corporation now owns 178 shares out of 270 shares of *X* corporation, while *C* owns 90 shares or one-third of the total.

The sole purpose of the transaction was to enable *C*, a key employee, to become a one-third owner of *X* corporation at a price he could afford to pay.

Section 302 of the Internal Revenue Code of 1954 relating to distributions in redemption of stock provides in part:

(a) GENERAL RULE.—If a corporation redeems its stock * * *, and if paragraph (1), * * * 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.

* * * * * * *

(d) REDEMPTIONS TREATED AS DISTRIBUTIONS OF PROPERTY.—Except as otherwise provided in this subchapter, if a corporation redeems its stock * * *, 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.

In the instant case, the redemption of 172 shares of stock of *X* corporation held by *Y* corporation reduced that corporation's percentage of stock ownership from 81 to 66 percent; however, it in no way impaired *Y*'s control of *X*. Although the transaction resulted in an increase in *C*'s interest in *X* corporation by 15 percent, it has relatively little effect on the status of the stockholdings of the two major stockholders. *Y* corporation still owns considerably more than

a majority of the outstanding stock of X corporation, and C continues as a minority shareholder. The net effect of the transaction was a distribution of the earnings of X corporation to the controlling shareholder without any appreciable change in position of the parties involved.

Accordingly, it is held that the distribution in redemption of a part of the stock of X corporation held by Y corporation was essentially equivalent to a dividend and, consequently, section 302(b)(1) of the Code is not applicable. Under the provisions of section 302(d) of the Code, the redemption is treated as a distribution to which section 301 applies, and is, therefor, taxable as a dividend to the extent provided in section 316 of the Internal Revenue Code of 1954.

Exchange of first-preference stock for common stock, bonds and cash pursuant to a proposed plan of reorganization. See Rev. Rul. 56–179, page 187.

Redemption of preferred stock does not constitute an exchange. See Rev. Rul. 56–265, page 156.

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26 CFR 1.302–2: Redemptions not taxable as dividends. Rev. Rul. 56–103

> Where a majority shareholder is also a beneficiary of his father's estate, a redemption by a corporation of that part of its capital stock held by the estate constitutes a distribution essentially equivalent to a dividend under the provisions of section 302(d) of the Internal Revenue Code of 1954, regardless of the fact that a part of such redemption is pursuant to a contract between the decedent and the corporation.

Advice has been requested relative to the Federal income tax consequences of a redemption by a corporation of a part of its common stock held by an estate.

Corporation A had only common stock outstanding of which 27 percent of the shares were owned by the estate of B, 48 percent by the decedent's son, and the remaining 25 percent by employees of the corporation who are unrelated to the decedent. The value of the estate of B is estimated at $250x$ dollars, including the 27 percent stock interest in corporation A. The sole beneficiary of the estate was the decedent's son.

In 1947 corporation A entered into an agreement with B, now deceased, which provided that the corporation would in the event of death purchase from his estate as many shares of its stock as could be purchased for $75x$ dollars. The purchase price per share of the stock was set at the book value as of the date of death. Under this contract the corporation was obligated to purchase 13 percent of the stock of corporation A from the estate.

The estate of B and the minority shareholders of corporation A desired to have the corporation acquire all of its stock owned by the estate. Accordingly, the corporation redeemed 13 percent of its stock from the estate for $75x$ dollars as provided in the contract, and,

in addition, redeemed the remaining shares (14 percent) of stock held by the estate at the same price.

Section 302 of the Internal Revenue Code of 1954 relating to distributions in redemption of stock, provides in part:

(a) GENERAL RULE.—If a corporation redeems its stock * * * 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.

Section 318(a) of the Code applies in determining the ownership of stock for purposes of section 302(b). Insofar as is pertinent, stock owned by a beneficiary of an estate is considered as being owned by the estate within the purview of section 318(a)(2)(A) of the Code.

In the instant case, the estate of *B*, for the purposes of section 302, is considered to own all of the stock owned by the sole beneficiary of the estate. Therefore, the estate owned 75 percent (27 percent plus 48 percent) of the shares of the corporation's stock. Hence, such a redemption did not qualify as a termination of a shareholder's interest or as a substantially disproportionate redemption under section 302(b)(2) and (3) of the Code.

Section 302(b)(1) of the Code with respect to redemptions treated as exchanges reads as follows:

* * * REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

In determining whether a distribution in redemption is essentially equivalent to a dividend, each case must be decided upon its own particular circumstances. The courts have held in many cases that whether a redemption of stock is essentially equivalent to a dividend depends primarily upon the net effect of the distribution rather than the motives and plans of the shareholders or the corporation. See *M. A. Flanagan et al.* v. *Helvering*, 116 Fed. (2d) 937; *James H. Boyle* v. *Commissioner*, 187 Fed. (2d) 557, certiorari denied, 342 U. S. 817; *Joshua E. Smith* v. *United States*, 121 Fed. (2d) 692. The absence of a plan to avoid taxation is not controlling. A redemption of stock which does not as a practical matter change the essential relationship between the stockholders and the corporation is generally considered equivalent to a dividend. See *John T. Roberts et al.* v. *Commissioner*, 203 Fed. (2d) 304.

As the relative stock interest of the principal shareholder was not materially changed by the redemption, the distribution to him is equivalent to a dividend. *J. Natwick* v. *Commissioner*, 36 B. T. A. 866; *W. & K. Holding Co.* v. *Commissioner*, 38 B. T. A. 830. The fact that the redemption is pursuant to a contract between the corporation and the decedent does not appear to be significant for this purpose.

Accordingly, it is held that (except to the extent that the distribution may qualify under the provisions of section 303 of the Code as a redemption of stock to pay death taxes) the redemption by the corporation of a part of its stock from the estate constituted a distribution essentially equivalent to a dividend. Such redemption is treated as a distribution of property to which section 301 applies as provided in section 302(d) of the Code, and is taxable as a dividend to the extent of earnings and profits of the corporation as defined in section 316 of the Code.

Rev. Rul. 56-183

Where certain members of related family groups holding 11 percent of the capital stock of a corporation sell part of their stock to the corporation for bona fide business purposes, the distribution received by the stockholders in redemption of such stock, to the extent it is not in excess of the fair market value of the stock redeemed, shall be treated as in full payment in exchange for the stock under the provisions of section 302(a) and (b)(1) of the Internal Revenue Code of 1954. The difference between the adjusted basis of the stock redeemed and the consideration received therefor, to the extent that the consideration received is not greater than the fair market value of such stock at date of redemption, constitutes capital gain or loss subject to the provisions and limitations of subchapter P of chapter 1 of the Code.

The Internal Revenue Service has been requested to state the Federal income tax consequences resulting from the redemption by a corporation of a portion of its capital stock under section 302 of the Internal Revenue Code of 1954.

The capitalization of corporation *M* consisted solely of one class of common stock. Prior to the redemption, 11 percent of the stock was owned by members of, and trusts created for the benefit of, four family groups descended from one common ancestor. Another five percent of the stock was held by trusts created for the benefit of cousins of these four families. The remaining 84 percent of the stock was owned by strangers to the shareholders described above. A portion of the stock held by four trusts (one for the benefit of individuals within each of the four family groups previously mentioned) was sold to corporation *M* in order that the trusts could diversify their investments. The stock so redeemed constituted about two percent of the outstanding stock of corporation *M*.

The shares of *M* corporation's stock which were redeemed at a specified price per share were not at the time quoted on any exchange or over the counter, and there was no ready market for them. The price paid was determined by reference to certain sales in recent years and the value accepted in recent estate and gift tax proceedings. The redemption of these shares was not made pursuant to any plan involving or in contemplation of other sales of the stock to the corporation by the selling shareholders or by any other shareholders.

The four selling shareholders as a group, together with their beneficiaries and the families of these beneficiaries, held approximately 11 percent of the outstanding stock of corporation *M* prior to the redemption and approximately nine percent after the redemption. More than 89 percent of *M*'s stock was at all times held by persons not closely related to or associated with the selling shareholders, their beneficiaries, or the families of the beneficiaries.

On the basis of these facts, it is held that (1) the redemption was not essentially equivalent to a dividend and, therefore, the consideration received by the shareholders in redemption of the shares of *M* corporation's stock shall be treated as a distribution in full payment in exchange for the stock in accordance with the provisions of section 302(a) and (b)(1) of the Internal Revenue Code of 1954, to the extent that the amount received is not greater than the fair market value of the stock redeemed, and (2) the shareholders realized a gain or loss equal to the amount of the difference between the adjusted basis of

the stock redeemed and the consideration received therefor, to the extent that the consideration received was not greater than the fair market value of such stock at the date of redemption. Such gain or loss constitutes a capital gain or loss subject to the provisions and limitations of subchapter P of chapter 1 of the Code.

SECTION 306.—DISPOSITIONS OF CERTAIN STOCK

26 CFR 1.306–1: General. Rev. Rul. 56–223
(Also Sections 354, 368; 1.354–1, 1.368–2.)

Pursuant to a plan of recapitalization, M corporation issued new preferred stock and common stock in exchange for its outstanding common stock. The transaction constituted a reorganization under section 368(a)(1)(E) of the Internal Revenue Code of 1954, and the exchanges were nontaxable under the provisions of section 354(a)(1). The preferred stock is section 306 stock within the meaning of section 306(c)(1)(B). Prior to the reorganization, an employees' trust created by *M* corporation had entered into an agreement with certain retiring employees to purchase their stock of the corporation over a six-year period. Under the terms of the agreement, the new common and preferred shares received in the reorganization will be substituted for the old shares and sold to the employees' trust. *Held*, such sales of new preferred stock by the retiring employees are not within the purview of section 306(a), and the resultant gain or loss will be treated as capital gain or loss.

The Internal Revenue Service has been requested to state its position with respect to the tax effect of a proposed sale of preferred stock received in a nontaxable exchange in pursuance of a plan of reorganization of a corporation.

Prior to the reorganization described below, the outstanding capital stock of *M* corporation consisted of shares of no-par common stock. Such stock was owned by approximately 100 stockholders, approximately 80 percent being owned by employees of the corporation. An employees' trust created by *M* corporation as a qualified profit sharing trust under the provisions of the Internal Revenue Code was also a stockholder.

In order that the employees of the corporation might continue in the future to own substantially all of *M's* voting stock, it was desired to recapitalize the corporation in such a way as to reduce the value of the voting stock to a price at which the employees would be able to purchase it. Accordingly, a plan of recapitalization was adopted under which *M* corporation issued shares of new preferred and common stock to its stockholders in exchange for their old common shares on the basis of one share of preferred stock and three shares of common stock for each share of old common stock exchanged. The transaction qualified as a reorganization under the provisions of section 368(a)(1)(E) of the Internal Revenue Code of 1954, and the exchanges of stock made pursuant to the plan were nontaxable to the stockholders under section 354(a)(1). The preferred stock received by the stockholders under the plan constituted section 306 stock within the meaning of section 306(c)(1)(B).

Prior to the reorganization, a certain corporation had expressed a desire to purchase the common stock of *M* corporation at a price not less than its book value. Certain older employees who were to be

retired over the following six years, with a view to liquidating their holdings of common stock of *M* corporation upon being no longer connected with the corporation, indicated a desire to sell their stock to such other corporation. These employees owned almost half of *M's* outstanding shares. If the sales were carried out, *M* corporation would lose its identity, and the employees' trust would likely be terminated or the corporation's contribution thereto greatly reduced. To meet this threat, the trust entered into an agreement with the retiring employees under which it agreed to purchase all of the stock of *M* corporation owned by the retiring employees over a six-year period. Pursuant to the terms of the agreement, one-sixth of the shares of each retiring employee was to be purchased by the trust in each year. Under the agreement, all stock of the retiring employees was placed in escrow.

The agreement was formulated on the basis of a single class of capital stock but contained a provision that, in the event *M* corporation changed its capital structure by issuing new shares in exchange for the shares then outstanding, the new shares would be subject to the agreement. Accordingly, the new preferred shares and the new common shares received by the retiring employees in the reorganization will be substituted for the old shares and held in escrow. Thereafter, in carrying out each sale to the trust called for by the agreement, the escrow agent, on behalf of each retiring employee, will transfer to the trust shares of both classes of new stock in the same ratio in which they were issued in the reorganization.

A ruling has been requested to the effect that the sale of preferred shares of *M* corporation to the trust by the retiring employees under the terms of the agreement is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax within the meaning of section 306(b)(4) of the Internal Revenue Code of 1954.

As to dispositions of section 306 stock, section 306 provides in part as follows:

> (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 * * *—
>
> (A) The amount realized shall be treated as gain from the sale of property which is not a capital asset. * * *
>
> * * * * * * *
>
> (b) EXCEPTIONS.—Subsection (a) shall not apply—
>
> * * * * * * *
>
> (4) TRANSACTIONS NOT IN AVOIDANCE.—If it is established to the satisfaction of the Secretary or his delegate—
>
> * * * * * * *
>
> (B) in the case of a prior or simultaneous disposition * * * of the stock with respect to which the section 306 stock disposed of * * * was issued, that the disposition * * * 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.

In the instant case, the disposition of section 306 stock is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Inasmuch as the retiring employees, pursuant to the terms of the agreement, are selling all of their stock, both preferred and common, of *M* corporation, the result of the sale to

them will be exactly the same as it would have been if the reorganization had never taken place and their old common stock had been sold under the agreement. By virtue of the provisions of section 306(b)(4), section 306(a) will not apply to the sale of their preferred shares to the trust.

Accordingly, under the facts in this case, the gain or loss realized by each of the retiring employees upon each sale of shares of his preferred stock and common stock to the trust will constitute capital gain or loss, subject to the provisions of Subchapter P of Chapter 1 of the 1954 Code. Under section 1223(1) of the Code, in determining the period for which a retiring employee has held the new preferred and common shares, there will be included the period for which he held the old common shares exchanged therefor.

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26 CFR 1.306–3: Section 306 stock defined. Rev. Rul. 56–116
(Also Sections 354, 368, 1.354–1, 1.368–1.)

In a proposed statutory merger of two corporations shares of common and preferred stocks in the surviving corporation are to be received in exchange for the surrender of common stock in the corporation to be absorbed. *Held*, no gain or loss will be recognized to the corporations merged or their stockholders under sections 368 and 354 of the Internal Revenue Code of 1954, and the provisions of section 306(a)(1) shall not be applicable to the proceeds of the disposition of the preferred stock which will be issued in the merger, unless such disposition is in anticipation of a redemption after the issuance of the stock.

Advice has been requested with respect to the tax consequences, for Federal income tax purposes, of a proposed transaction hereinafter described.

Under a plan providing for the merger of *Y* corporation into *X* corporation, both preferred stock and voting common stock of *X* will be issued in exchange for the common stock of *Y*.

The common stocks of both *Y* and *X* are widely held, and these corporations are not related through the ownership of their common stocks.

After the merger, the total percent of common stock in *X* held by the former *Y*'s stockholders will be less than 20 percent.

The reasons for issuing both preferred and common stocks of *X* in exchange for stock of *Y* are that the business of *X* has shown more dynamic growth over the period of the last several years than has that of *Y* and it is therefore desired to limit the extent to which the former *Y*'s stockholders may share in the future growth of the common equity. By limiting the amount of *X*'s common stock issued to the former *Y*'s stockholders, there will be less dilution of the voting power of the present *X*'s common stockholders.

The management of *X* has no intention of redeeming any of the preferred stock which would be issued in the merger, except as required under the provisions of the purchase fund and the sinking fund agreements, the terms of which are not here relevant.

Section 368(a)(1)(A) of the Internal Revenue Code of 1954 provides that the term "reorganization" includes a statutory merger or consolidation; section 368(b) provides that the term "a party to a reorganization" includes both corporations, in the case of a reorgani-

zation resulting from the acquisition by one corporation of stock or properties of another; and section 354(a) provides that 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. Pursuant to the afore-mentioned sections of the Code, it is held that no gain or loss will be recognized to *Y*, *X* or their stockholders from the proposed statutory merger of *Y* into *X*.

The term "section 306 stock" means stock which meets the requirements of subparagraph (A), (B), or (C) of section 306(c)(1). Subparagraph (B), which is applicable to the instant case, provides as follows:

> (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.

Section 1.306–3(d) of the regulations under Subchapter C, as published in Treasury Decision 6152, C. B. 1955–2, 61, provides, in part, as follows:

> Ordinarily, section 306 stock includes stock which is not common stock received in pursuance of a plan of reorganization (within the meaning of section 368(a)) or received in a distribution or exchange to which section 355, (or so much of section 356 as relates to section 355) applies if cash received in lieu of such stock would have been treated as a dividend under section 356(a)(2) or would have been treated as a distribution to which section 301 applies by virtue of section 356(b) or section 302(d).

As to dispositions of "section 306 stock," section 306 provides, in part, as follows:

> (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 * * *
>
> (A) The amount realized shall be treated as gain from the sale of property which is not a capital asset. * * *
>
> * * * * * * *
>
> (b) EXCEPTIONS.—Subsection (a) shall not apply—
>
> * * * * * * *
>
> (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
>
> * * * * * * *
>
> was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."

It is held that the preferred stock received in connection with the merger is "section 306 stock" as provided by section 306(c)(1)(B) of the 1954 Code. It is further held that the provisions of section 306(a)(1) of the 1954 Code shall not be applicable to the proceeds of

the disposition of the preferred stock of *X* which will be issued in the merger, unless such disposition is in anticipation of a redemption after the issuance of the stock. See section 1.306–2(b)(3) of the regulations under Subchapter C, Treasury Decision 6152, *supra*.

SUBPART C.—DEFINITIONS; CONSTRUCTIVE OWNERSHIP OF STOCK

SECTION 316.—DIVIDEND DEFINED

26 CFR 1.316–1: Dividends. Rev. Rul. 56–153
(Also Sections 453, 1221.)
(Also Part II, Sections 44(b), 115(a), 117(a); Regulations 118, Sections 39.44–1, 39.115(a)–1, 39.117(a)–1.)

Amounts received by a taxpayer (vendor) representing dividends paid on shares of stock which he sold and holds in trust to secure payment of a promissory note given by the vendee for the purchase price of the stock, which dividends from such stock held in trust are applied against payment of interest and principal on the note until it is fully paid, do not constitute dividends to the taxpayer (vendor) within the meaning of section 316(a) of the Internal Revenue Code of 1954. Such dividends constitute taxable income to the vendee.

The shares of stock sold under such circumstances constitute a capital asset as defined in section 1221 of the Code, and on the facts stated the sale of the stock qualifies under the provisions of section 453(b) of the Code as an installment sale of personalty, the gain on which is reportable on the installment basis as provided in section 39.44–1 of Regulations 118, made applicable by Treasury Decision 6091, C. B. 1954–2, 47.

I. T. 1958, C. B. III–1, 111 (1924), revoked.

Advice has been requested whether amounts received by an individual, such amounts representing dividends paid on shares of stock which he sold and holds in trust to secure payment of a promissory note given for the purchase price of the stock, the dividends to be applied as payment of interest and principal on the note until fully paid, constitute dividends to him within the meaning of section 316(a) of the Internal Revenue Code of 1954. Advice has also been requested whether such shares of stock represented a capital asset as defined in section 1221 of the Code, and whether the payments received on the principal of the note may be reported, for Federal income tax purposes, on the installment basis as provided in section 453(b) of the Code.

Taxpayer, together with another individual and a separate corporation, none of whom are dealers in securities, owned all of the issued and outstanding stock of *M* company. The three stockholders, after having held their shares of stock in *M* company for more than six months, sold such shares of stock to *X* corporation for a sum of 3,000*x* dollars, payable 1,700*x* dollars to the taxpayer and the balance to the second individual and the separate corporation. An initial cash payment of 735*x* dollars was made to the sellers at the time of the sale, of which 136*x* dollars was paid to the taxpayer, the balance to the other two sellers. Taxpayer received, in addition to the cash, a negotiable promissory note made by *X* corporation, payable to his order, for the balance of his share of the purchase price. The note and interest

thereon are payable in quarter-annual installments, with a final payment payable ten years after the date of the note. *X* corporation, maker of the note, is unconditionally liable for payment of the note and interest. At the time of the sale entries were made on the books of *M* company indicating the transfer of the stock to *X* corporation.

Both corporation *X* and corporation *M* are actively engaged in retail merchandising. Prior to the consummation of the above-described sale, none of the stockholders of *M* company owned, directly or indirectly, any stock of *X* corporation; neither did any of the stockholders of *X* corporation own, directly or indirectly, any stock of *M* company.

Concurrently with the sale of the shares of stock of *M* company, a collateral trust agreement was entered into between taxpayer and *X* corporation whereby *X* corporation transferred to taxpayer, as trustee, to hold and possess for the security and benefit of the holders of the notes until fully paid, all of the shares of the stock of *M* company as well as all the shares of stock of a wholly-owned subsidiary company previously acquired by *X* corporation. The trust agreement grants to the trustee the power to vote the shares of both *M* company and the subsidiary company provided, *inter alia*, that the shares be voted so as to elect designees of *X* corporation to the boards of directors of both *M* company and the subsidiary company as specified therein. It further provides that the trustee, having voting rights of all the common stock, shall use his best efforts to cause the directors of the two companies to declare and pay out of earnings as dividends on common stock such amounts as shall be designated by *X* corporation to provide funds for quarterly payments on the promissory note, but not for any other purpose unless with written consent of *X* corporation. The trustee is to collect all dividends so paid by *M* company and the subsidiary company, and apply them to principal and interest on the note. If the cash received by the trustee is not sufficient to make such quarter-annual payments, payment of interest and principal is to be deferred, and *X* corporation is required to make out of its funds, other than those held by the trustee, payments up to the amount required for an annual payment on the note. The trustee will not deliver the shares of *M* company's stock to *X* corporation until the note is paid in full.

Section 316(a) of the Code defines dividends as any distribution made by a corporation to its shareholders, whether in money or in other property. Section 39.115(a)–1 of Regulations 118, made applicable herein by virtue of Treasury Decision 6091, C. B. 1954–2, 47, states that a taxable distribution made by a corporation to its shareholders shall be included in gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

In the case of *Estate of Arthur L. Hobson et al.* v. *Commissioner*, 17 T. C. 854, acquiescence, C. B. 1952–1, 2, Hobson agreed to sell certain shares of stock. The total consideration involved was payable over a designated period of time during which Hobson, the vendor, was to remain record owner and in possession of the shares until the purchase price was fully paid. Hobson was to credit any and all dividends paid to him by reason thereof against the purchase price. The court held that the amounts received by Hobson by reason of retaining title to the stock, but applied by him against the purchase

price thereof, were not ordinary income to Hobson but were dividends which belonged to the vendee and were taxable to him.

To similar effect are the cases of *Charles B. Long* v. *United States*, 66 Ct. Cl. 475, and *Frederick M. Lee* v. *Commissioner*, 143 Fed. (2d) 4, where the legal title to the stock sold was held by a trustee in trust for the sole purpose of securing the payment of the purchase price; and the cases of *Fay Harvey Moore* v. *Commissioner*, 124 Fed. (2d) 991, *Helen A. DeGuire, Executrix under will of George N. DeGuire* v. *Higgins*, 159 Fed. (2d) 921, certiorari denied, 331 U. S. 858, and *Northern Trust Co. of Chicago, Executor under will of Aleta M. Gomoll* v. *United States*, 193 Fed. (2d) 127, certiorari denied, 343 U. S. 956, where stock certificates and purchase money notes were placed in escrow pending payment of the purchase price and legal title to the stock sold was retained by the vendor for the sole purpose of securing payment of the purchase price.

The principle of the cases referred to above is considered applicable to the instant case where legal title to the stock sold is held by the vendor, as trustee, pending payment of the notes of the vendee issued in part payment therefor, for the sole purpose of securing payment of the purchase price.

Section 1221 of the Code, so far as here pertinent, defines the term "capital asset" as meaning property held by the taxpayer, whether or not connected with his trade or business, which is not stock in trade, property which is properly to be included in inventory, or property held primarily for sale to customers in the ordinary course of business, and which is not property used in trade or business which is subject to the allowance for depreciation.

Section 453(b) of the Code provides that income from a casual sale or other casual disposition of personal property, other than property of a kind which should properly be included in inventory, may be reported on the installment basis as provided in section 453(a) if the sale price exceeds $1,000 and the payments made during the taxable year in which the sale was made, exclusive of evidence of indebtedness of the purchaser, do not exceed 30 percent of the selling price. Section 39.44–1(b) of Regulations 118, made applicable herein by Treasury Decision 6091, C. B. 1954–2, 47, provides that if a taxpayer makes a proper election pursuant to section 44 of the Internal Revenue Code of 1939 to report income on the installment basis, there is reportable as income in any taxable year only 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.

Accordingly, in view of the foregoing, it is held:

1. That the amounts representing dividends on the *M* company's stock received by the instant taxpayer (vendor) in his capacity as trustee of the stock to secure the payment of principal and interest on the note of *X* corporation which he holds for the balance of the sale price of such stock, which amounts are applied against installments falling due under the note, do not constitute dividends to him within the meaning of section 316(a) of the Code. Such dividends constitute ordinary income to the *X* corporation, the vendee.

2. Since this taxpayer is not a dealer in securities, and his shares of stock in *M company* were not held for sale to customers in the

ordinary course of business, his shares of stock in *M* company constituted a capital asset, and since such shares were held for more than six months, any gain on the sale of the shares constitutes long-term capital gain subject to the provisions of section 1202 of the Code.

3. Inasmuch as the initial payments for the purchase of the stock of *M* company, received by the taxpayer during the taxable period in which the sale was made were less than 30 percent of a selling price exceeding $1,000, the sale qualifies as an installment sale of personalty, the gain from which may be reported for Federal income tax purposes on the installment basis as provided in section 39.44–1 of Regulations 118, made applicable herein by Treasury Decision 6091, C. B. 1954–2, 47.

I. T. 1958, C. B. III–1, 111 (1924), which held that dividends received by a bank as depositary of shares of stock sold by a taxpayer (vendor) and credited to his account, but subsequently applied to reduce the purchaser's (vendee's) liability for the unpaid balance of the purchase price of the stock, constituted taxable income to the vendor, is hereby revoked.

Under the provisions of section 7805(b) of the Internal Revenue Code of 1954, the Service will not require the provisions of this Revenue Ruling to be applied retroactively, in the case of a vendee, to taxable years beginning prior to July 1, 1952, the beginning of the month following the announcement in the Internal Revenue Bulletin of the Commissioner's acquiescence in the decision of the Tax Court of the United States in *Estate of Arthur L. Hobson et al.* v. *Commissioner*, *supra*.

A distribution by one corporation to a corporate stockholder of another corporation in redemption of such stock. See Rev. Rul. 56–182, page 157.

Stock of a new corporation distributed by the corporation which had transferred part of its assets therefor. See Rev. Rul. 56–227, page 183.

A distribution by subsidiary corporation to its parent. See Rev. Rul. 56–265, page 156.

A distribution of stock of controlled corporation. See Rev. Rul. 56–266, page 184.

PART II.—CORPORATE LIQUIDATIONS

SUBPART A.—EFFECTS ON RECIPIENTS

SECTION 332.—COMPLETE LIQUIDATIONS OF SUBSIDIARIES

26 CFR 1.332–1: Distributions in liquidation of subsidiary corporation.

Distribution by a liquidating corporation of 80 percent or more of its assets to a new corporation. See Rev. Rul. 56–212, page 170.

SECTION 333.—ELECTION AS TO RECOGNITION OF GAIN IN CERTAIN LIQUIDATIONS

26 CFR 1.333–1: Corporate liquidation in some one calendar month. (Also Sections 332, 334, 336, 381; 1.332–1, 1.334–1, 1.336–1.) Rev. Rul. 56–212

Nineteen percent of the outstanding stock of a corporation is owned by an individual and the remaining outstanding stock is owned by another corporation. The liquidation of the former corporation will, under the facts, meet the requirements of section 333 of the Code, thereby entitling the minority stockholder to the benefits of such section and at the same time it will meet the requirements of section 332 of the Code with respect to the distribution of the remaining assets to the majority stockholder.

Advice has been requested with respect to the tax consequences of a proposed liquidation of *M* corporation under the circumstances set forth below.

M corporation is a personal holding company as defined in section 542 of the Internal Revenue Code of 1954. Its balance sheet reflects assets having a book value of 9,000x dollars, accrued liabilities amounting to 3x dollars, and capital stock and surplus of 8,997x dollars. The assets include investments in stock of *X* and *Y* corporations and other marketable securities amounting to 6,000x dollars, 200x dollars and 2,000x dollars, respectively. The investments in *X* and *Y* corporations are substantially in excess of 80 percent of the outstanding stock of each of the said corporations.

The *M* corporation has only common stock outstanding, of which 19 percent is held by *B*, an individual, and the remaining 81 percent is held by *R* corporation.

Within recent years *B*, the minority stockholder, determined, because of age and poor health, to withdraw from the active pursuit of business. As an essential part of his retirement program, he decided to dispose of his stock holdings in *M* corporation. The *R* corporation also desired to acquire the investment assets of *M* corporation. In order to obtain the desired results, *R* corporation and *B* agreed on a program of liquidating the *M* corporation. The program contemplates the complete liquidation of the said corporation within some one calendar month of 1955. Pursuant to the adopted plan, 19 percent of the assets of *M* corporation will be distributed to *B* and the remaining 81 percent will be distributed to *R* corporation.

It is the present intention of the parties owning the stock of *R* corporation to continue the corporate existence of that corporation for an indefinite period as a family investment corporation and to utilize it from time to time as an appropriate corporate vehicle into which to liquidate various other corporations owned in whole or in part by the same interests.

Sections 332 and 333 of the Internal Revenue Code of 1954, which cover the primary issues involved in the above-described transactions, provide, in part, as follows:

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 * * *

(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; * * *.

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.

* * * * * * *

(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.

Based upon the foregoing facts and circumstances, it is held as follows:

(1) The minority stockholder, *B*, will be entitled to the benefits of section 333 of the Code, provided the requirements of that section are met. *R* corporation, being an excluded corporation within the meaning of subsection (b) of section 333 of the Code, will not be entitled to the benefits of that section. As provided by section 334(c) of the Code, the basis of the assets acquired by *B* will be the same as

the cost or other basis of the stock of *M* corporation owned by him, decreased in the amount of any money received, and increased in the amount of any gain recognized.

(2) The distribution by *M* corporation of 81 percent of its assets to *R* corporation, in complete cancellation or redemption of the stock of *M* corporation held by *R* corporation, will result in no gain or loss to *R* corporation upon the receipt of the assets from *M* corporation under section 332 of the Code, provided all the provisions of that section are met. The basis of such assets in the hands of *R* corporation will be the same as it would be in the hands of the *M* corporation, under section 334(b)(1) of the Code.

(3) No gain or loss will be recognized to *M* corporation upon the complete liquidation thereof within some one calendar month of 1955, under section 336 of the Code.

(4) The earnings and profits of *M* corporation at the time of the liquidation, which are properly applicable to the assets distributed to *R* corporation, will become earnings and profits of the latter corporation, under section 381 of the Code.

Rev. Rul. 56–286

Tax treatment of the liquidation, under section 333 of the Internal Revenue Code of 1954, of a personal holding company whose assets consist of cash and stocks in 24 different corporations and where actual distributions of those assets to its shareholders within any one calendar month is physically impossible.

Advice has been requested as to the method of complying with section 333 of the Internal Revenue Code of 1954 with respect to certain investment stocks transferred by a personal holding company upon complete liquidation to its qualified electing shareholders. Section 333 of the Code requires, among other things, that "the transfer of all the property under the liquidation" shall occur within some one calendar month.

The corporation's assets consist of cash and common stocks of twenty-four different corporations. By reason of the number of stocks and transfer agents involved, it is possible that the actual issuance of new certificates by one or more of the transfer agents or the actual physical delivery of new certificates to the transferee shareholders may not take place until after the expiration of the calendar month selected for the distribution. A pro rata distribution among the corporation's shareholders involves fractional shares which may not be procurable. Furthermore, there will be cash and stock dividends payable after the end of the calendar month to shareholders of a record date prior to the issuance by the transfer agent of new certificates to the transferee shareholders.

In view of the problems involved, the Internal Revenue Service holds as follows:

(1) For the purposes of section 333 of the Internal Revenue Code of 1954, the transfer to the shareholders of the corporation of their respective interests in stock owned by the corporation will occur on

the date of mailing the original certificates to the transfer agent thereof, accompanied by assignments thereof and instructions directing the issuance of new certificates in the name of the transferee shareholders.

(2) The provisions of section 333 of the Code will be met if, during the calendar month of liquidation, certificates for the aggregate of any fractional shares involved are issued to a designated nominee and irrevocable instructions are given by the corporation to the nominee (a) to sell the certificates for the account of the corporation's shareholders and (b) to distribute the proceeds among the shareholders in accordance with their respective interests in such fractional shares.

(3) If any corporation, in which the instant corporation owns stock declares a cash or stock dividend payable or issuable after the end of the calendar month selected for distribution to shareholders of record determined as of a record date, prior to the date of issuance by the transfer agent of new certificates in the name of the transferee shareholders, and within such calendar month the corporation executes and delivers to the respective transferee shareholders irrevocable assignments of any interest in such dividends, it will be considered a satisfactory compliance with the provisions of section 333(a)(2) of the Code relative to the distribution of all of the property under the liquidation within one calendar month.

(4) The requirements of section 333(a)(2) of the Code will be considered to have been complied with if the corporation sets aside a reserve fund, consisting of cash and cash dividends payable after the end of the calendar month selected for distribution, to provide for the payment after the close of such calendar month of any unpaid attorneys' fees, accountants' fees, and other expenses of liquidation and dissolution, as well as of unascertained and contingent liabilities and expenses, if such reserve is set aside in good faith and the amount thereof is reasonable.

SECTION 334.—BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS

26 CFR 1.334–1: Basis of property received in liquidation.

Basis of the assets acquired by a minority stockholder. See Rev. Rul. 56–212, page 170.

SUBPART B.—EFFECTS ON CORPORATION

SECTION 336.—GENERAL RULE

26 CFR 1.336–1: General rule on liquidation of corporation.

Recognition of gain or loss upon liquidation of corporation within some one calendar month. See Rev. Rul. 56–212, page 170.

SUBPART C.—COLLAPSIBLE CORPORATIONS; FOREIGN PERSONAL HOLDING COMPANIES

SECTION 341.—COLLAPSIBLE CORPORATIONS

26 CFR 1.341–1: Collapsible Corporations— In general. Rev. Rul. 56–50

Where a corporation holding stock in a collapsible subsidiary corporation sells all of its stock in such subsidiary corporation and the gain on the sale of the stock is taxable as provided for in section 341(a) of the Internal Revenue Code of 1954, the gain realized by the shareholders of the holding corporation upon liquidation of the holding corporation is not taxable in the manner provided for in section 341(a) of the Code.

Advice has been requested as to the application of the provisions of section 341 of the Internal Revenue Code of 1954, relating to collapsible corporations, to a gain realized by stockholders of a corporation upon liquidation under the circumstances described below.

Two individuals, engaged in the construction business, undertook in 1951 to construct and operate five separate apartment buildings as a joint venture through corporations which they would control. Accordingly, they organized one corporation, issuing shares of stock therein to themselves equally, and five additional corporations, transferring to each of the five corporations one-fifth of a tract of land owned by one of the individuals, one F. H. A. mortgage commitment, and other items in exchange for all of the capital stock of each additional corporation. The shares of the five corporations were then transferred to the original corporation by the two shareholders as a contribution to capital. Construction of the first of the apartment buildings was begun in September, 1951, and the fifth and last building was completed in October, 1953. The stock in the five subsidiaries comprised virtually all of the assets of the parent corporation. Due to a dispute between the stockholders of the parent corporation, which resulted in court action, the court entered a judgment in 1954 ordering the dissolution of the joint venture, appointed trustees to take possession of the outstanding stock of the parent corporation, and directed that the assets of the corporation, consisting of the stock of the five subsidiaries, be liquidated and the proceeds of such liquidation be distributed by the trustees at such time and in such manner as the court should direct. The trustees did not cause any of the corporations, parent or subsidiaries, to adopt any resolution with respect to liquidation. Later in 1954, an individual not related in any way to either of the two shareholders purchased from the parent corporation, in a transaction to which section 337 of the Code does not apply, all of the outstanding shares of stock of the five subsidiaries for cash and promissory notes. At the time of the sale, all five apartment buildings were substantially occupied by tenants. The proceeds of the sale are to be distributed in liquidation of the parent corporation and, after payment of expenses and claims, are to be held by the trustees pending court determination of the conflicting rights and obligations of the two shareholders.

Under the provisions of section 341(b) of the Code, a "collapsible corporation" is defined as follows:

(b) DEFINITIONS.—

(1) COLLAPSIBLE CORPORATION.—For the 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.

Whether the five subsidiary corporations fall within the definition of a collapsible corporation is primarily a question of fact and hence is for determination upon the audit of the income tax return of the parent corporation for the year in which the stock of the subsidiaries was sold, rather than for issuance of a ruling, under the policy stated in section 6 of Revenue Ruling 54–172, C. B. 1954–1, 394, at 398.

The question has nevertheless been raised whether the parent corporation is a collapsible corporation on the assumption that the subsidiary corporations fall within the definition contained in section 341(b) of the Code. On that assumption, the gain of the parent corporation from its sale of the stock of the subsidiary corporations is required by section 341(a)(1) of the Code to be considered as gain from the sale or exchange of property which is not a capital asset, so that the corporate tax on the realization of ordinary income attributable to the construction of property by the subsidiaries is not avoided.

It will be noted that section 341(b), *supra*, defines a collapsible corporation so as to include not only a corporation formed or availed of with a view to the realization by its shareholders of gain attributable to property produced by the corporation, as more fully set out therein, but also to include a corporation formed or availed of "for the holding of stock in a corporation so formed or availed of." It will be further noted that section 341(b)(1)(A) of the Code refers only to the realization of income by the corporation producing the property. If, prior to such realization, the parent and subsidiary corporations are both liquidated or the stock of the parent corporation is sold, section 341 of the Code is automatically applicable to the parent corporation.

A literal reading of the statute would seem to produce the same result even though the parent corporation had first realized ordinary income by virtue of its sale of the entire stock of the collapsible subsidiary. Since the statute refers only to the realization of taxable income by the corporation producing the property, and not to any realization by the corporation holding its stock, it would appear under the literal language of the statute that the corporation holding stock of a collapsible corporation would still be a collapsible corporation even though it had been taxed as the shareholder of a collapsible corporation.

However, to impose the tax treatment provided for in section 341(a) of the Code twice as to the same underlying collapsible property would extend the statute beyond its intended purpose. The legislative history of section 117(m) of the Internal Revenue Code of 1939, as amended by section 326 of the Revenue Act of 1950, from which section

341 of the 1954 Code originally stems, makes it clear that the objective was to prevent the successful use of a device for converting ordinary income into long-term capital gain through the medium of a corporation. See H. R. Report No. 2319 and Senate Report No. 2375, Eighty-first Congress, C. B. 1950–2, pages 380 and 483, respectively, at pages 422, 449, 516, and 546. Where ordinary income is realized at the corporate level by the sale of the stock of a collapsible subsidiary, the evil at which the statute was aimed is not present and the effect of the literal interpretation suggested earlier would be to impose what would amount to a penalty tax at the shareholder level through requiring the gain attributable to property produced by a collapsible subsidiary to be taxed at both levels as ordinary income. There is no evidence in the legislative history that Congress intended such a result. Thus, it would be unreasonable to adopt the suggested literal interpretation. See *Holy Trinity Church* v. *United States*, 143 U. S. 457, at 459; *Helvering* v. *New York Trust Company*, 292 U. S. 455, at 464, Ct. D. 840, C. B. XIII–1, 188, at 190 (1934); *Haggar Company* v. *Helvering*, 308 U. S. 389, at 394, Ct. D. 1433, C. B. 1940–1, 237, at 239; and *United States* v. *American Trucking Associations, Inc., et al.*, 310 U. S. 534, at 543.

Accordingly, it is held that where a corporation holding stock in a collapsible subsidiary corporation sells all of its stock in such subsidiary corporation and the gain on the sale of the stock is taxable as provided in section 341(a) of the Code, the gain realized by the shareholders of the holding corporation upon liquidation of the holding corporation is not taxable in the manner provided for in section 341(a) of the Code.

Rev. Rul. 56–244

Where a corporation is completely liquidated for bona fide business reasons before the realization by the corporation of gain attributable to inventory, the gain realized by the shareholders upon such liquidation is not taxable as ordinary income under section 341 of the Internal Revenue Code of 1954 in a situation in which the inventory of the corporation at the time of liquidation is normal for the volume of sales and is no more than the average inventory over the past several years.

Advice has been requested whether the gain realized by the shareholders on the complete liquidation of a corporation engaged in selling for its own account is taxable as ordinary income in the manner provided in section 341 of the Internal Revenue Code of 1954. At the time of liquidation, each shareholder owned more than five percent of the outstanding stock.

From 1945 until the date of its liquidation in 1955, the corporation was actively engaged in the business of selling oil drilling equipment out of inventory in a particular state. The corporation originally sold directly to customers, but for the two years immediately prior to the liquidation it sold its products largely through supply companies. The corporation owned no real estate and had only a moderate amount of fixed assets which consisted of trucks, machine shop equipment, furniture, and fixtures.

In the past, the corporation did a large amount of business, but during the year preceding liquidation its sales declined sharply due to

a great increase in competition. A survey made at the time indicated that the number of oil field supply houses in the state was exorbitantly out of proportion to the number of drilling rigs in operation. It also appeared that the amount of oil already available was sufficient to discourage new exploration.

Immediately prior to the liquidation, the corporation abolished the position of its sales manager, affected a reduction in rents for its quarters, reduced the salaries of its officers, and curtailed its new inventory purchases.

Because of the business conditions described, the corporation was liquidated in 1955, and the inventory remaining on hand was transferred to a partnership (composed of the former stockholders) which continued the business on a small scale. For several years preceding liquidation, inventory purchases were generally no larger than those required to replace inventory sold, so that at the time of liquidation the inventory was normal for the amount of business done and no greater than the average inventory for the same period.

Section 341, relating to collapsible corporations, in part provides:

(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.

* * * * * * *

(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; * * *

Section 1.341–2(a)(3) of the Income Tax regulations provides that:

(3) A corporation is formed or availed of with a view to the action described in section 341(b) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall,

in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.

Section 1.341–5(c)(1) of the Income Tax Regulations provides as follows:

(c) The absence of any of the facts set forth in paragraph (b) of this section or the presence of the following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (a) of this section) to establish that a corporation is not a collapsible corporation:

(1) In the case of a corporation subject to the rules of paragraph (b) of this section only by reason of the manufacture, construction, production, or purchase (either by the corporation or by another corporation the stock of which is held by the corporation) of property which is property described in section 341(b)(3)(A) and (B), the amount (both in quantity and value) of such property is not in excess of the amount which is normal—

(i) For the purpose of the business activities of the corporation which manufactured, constructed, produced, or purchased the property if such corporation has a substantial prior business history involving the use of such property and continues in business, or

(ii) For the purpose of an orderly liquidation of the business if the corporation which manufactured, constructed, produced, or purchased such property has a substantial prior business history involving the use of such property and is in the process of liquidation.

In view of the foregoing facts and circumstances and since the inventory was normal for the purpose of an orderly liquidation of the business, it is accordingly held that the gain realized by the shareholders upon liquidation of the corporation is not taxable as ordinary income within the purview of section 341 of the 1954 Code.

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26 CFR 1.341–2: Definitions. (Also Part II, Section 117(m); Regulations 118, Section 39.117(m)–1.) Rev. Rul. 56–104

A corporation, the capital stock of which is owned by a United States citizen, which corporation is organized and operated in a foreign country and realizes substantially all of the income to be derived from its property prior to its liquidation or the sale of its capital stock, does not constitute a collapsible corporation within the meaning of section 341(b) of the Internal Revenue Code of 1954. The mere fact that a corporation is a foreign corporation deriving all of its income from sources without the United States, and therefore has no "taxable income" for Federal income tax purposes, does not in and of itself cause it to be considered a collapsible corporation as defined in section 341(b) of the Code. No opinion is expressed as to whether the corporation is a foreign personal holding company for the purposes of Part III, Subchapter G, Chapter 1 of the 1954 Code.

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26 CFR 1.341–4: Limitations on application of section. Rev. Rul. 56–137

In 1952 a corporation purchased a tract of land for the purpose of constructing a shopping center thereon and operating the shopping

center when it was completed. As a step in the construction, the corporation petitioned the local board of commissioners to rezone the land from residential to commercial, which petition was granted. However, complaints filed by various parties objecting to the rezoning resulted in litigation over a period of years, and in 1954 the right to proceed with the development in accordance with the zoning ordinance was finally declared valid and effective. *Held*, for the purposes of section 341 of the Internal Revenue Code of 1954, relating to collapsible corporations, the rezoning constitutes an integral step in the construction of the shopping center and, if the corporation has no other construction activity with relation to the land subsequent to the date the rezoning became final, the three-year period, for the purposes of section 341(b)(3) and section 341(d)(3) of the Code, begins on the day following the date the rezoning became final. Compare I. T. 3287, C. B. 1939–1 (Part 1), 138, and I. T. 3705, C. B. 1945, 174.

PART III.—CORPORATE ORGANIZATIONS AND REORGANIZATIONS

SUBPART B.—EFFECTS ON SHAREHOLDERS AND SECURITY HOLDERS

SECTION 354.—EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS

26 CFR 1.354–1: Exchanges of stock and securities in certain reorganizations. Rev. Rul. 56–171

Where stock is acquired in the surviving corporation by certain corporate stockholders of a merged corporation, the acquisition date of the stock of the surviving corporation, for purposes of section 333(f)(1) of the Internal Revenue Code of 1954, is the date of acquisition of the stock of the merged corporation surrendered in the exchange.

Advice has been requested as to the acquisition date of stock acquired in connection with a statutory merger.

Both *M* and *N* corporations were engaged in the business of supplying similar equipment through subsidiaries and affiliates. *M*'s outstanding capital stock consisted of participating common stock and common stock. *N*'s outstanding capital stock consisted of convertible preferred stock, cumulative preferred, and common stock.

M corporation merged with and into *N* corporation believing that the combined operations of the two corporations would effect economies of operation and substantial savings in overall operating costs. The merger was carried out as a statutory merger under the laws of the states in which the two corporations were organized. Under the plan, the holders of participating common stock and common stock of *M* corporation received two shares of voting common stock of *N* corporation in exchange for each share of *M*'s stock held. The holders of the preferred and common stock of *N* were not affected by the exchange. The merger presented an adequate corporate business purpose and constituted a "reorganization" within the meaning of section 368(a)(1)(A) of the Internal Revenue Code of 1954. The exchange by the stockholders of *M* corporation was nontaxable under section 354 of the Code.

At issue in the instant case is the date of acquisition of *N* corporation's stock received in the merger by certain corporate stockholders of *M* corporation which acquired their stock of *M* corporation prior to December 31, 1953, and which may wish to liquidate under section 333 of the Code.

Based upon the facts in the instant case, it is held that, for the purpose of section 333(a)(2) and 333(f)(1) of the Code, the acquisition date of *N* corporation's stock acquired by a corporate stockholder of *M* corporation in exchange for *M* corporation's stock pursuant to the merger is the date of acquisition of *M* corporation's stock surrendered in the exchange.

An exchange of preferred and common stock between two corporations pursuant to a merger. See Rev. Rul. 56–116, page 164.

Exchange of first preference stock for bonds and common stock pursuant to a plan of reorganization. See Rev. Rul. 56–179, page 187.

The treatment of stockholders in exchange pursuant to a reorganization. See Rev. Rul. 56–184, page 190.

Exchanges made by a corporation to its shareholders for new preferred and common shares in lieu of old common stock now outstanding. See Rev. Rul. 56–223, page 162.

SECTION 355.—DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION

26 CFR 1.355–1: Distribution of stock and securities of a controlled corporation. (Also Section 368, 1.368–1.) — Rev. Rul. 56–117

> Corporation *M* owned all of the common stock and 12 percent of the preferred stock of corporation *N* and had owned all of such shares for over five years. Because of differences of opinion existing in management, a group of stockholders of corporation *M* desired to terminate their stock interest in corporation *M* and acquire control of corporation *N*. A plan was evolved and put into effect whereby (1) corporation *N*, pursuant to a plan of reorganization, issued additional shares of its common stock in exchange for the shares of its preferred stock owned by stockholders other than corporation *M*, and (2) corporation *M* then distributed all of the common stock and preferred stock of corporation *N* held by it (then constituting 93 percent of the common stock and 100 percent of the preferred stock) to the stockholders of the dissatisfied group in exchange for all of their stock of corporation *M*. *Held*, no gain or loss is recognized to such stockholders on the receipt of the stock of corporation *N*, in view of the provisions of section 355 of the Code.

Advice has been requested whether the distribution by a corporation of its shares of the common stock and preferred stock of another

corporation to a group of its stockholders in exchange for their stock of the distributing corporation constituted a nontaxable transaction.

Corporation *M*, a domestic corporation engaged in the hardware business, owned all of the common stock and 12 percent of the preferred stock of corporation *N*, a domestic corporation engaged in the appliance business at a different location. Both corporations had been engaged in the active conduct of their respective businesses for more than five years, and all of the stock of corporation *N* owned by corporation *M* had been owned by it for more than five years. The preferred stock of corporation *N* had no voting power, sole voting rights being vested in the common stock. The outstanding stock of corporation *M* consisted solely of common stock.

Differences of opinion had arisen among the stockholders and directors of corporation *M* as to the basic policies of management and operation of the corporations. The differences became so pronounced that the stockholders concluded they could not continue the united ownership and management of the two corporations. A group of dissatisfied stockholders, who owned approximately one-half of the stock of corporation *M* and who were primarily concerned with the business of corporation *N*, offered to surrender all of their *M* stock to corporation *M* in exchange for the common stock and preferred stock of corporation *N* owned by corporation *M*. The proposal was accepted by the other stockholders, and, in order to equalize the value of the stocks being exchanged, corporation *M* transferred an amount of cash to corporation *N* as a capital contribution.

Prior to the separation, in pursuance of a plan of recapitalization, corporation *N* issued additional shares of its common stock in exchange for the outstanding shares of its preferred stock owned by stockholders other than corporation *M*, the exchange ratio being based upon the respective values of the preferred and common shares. The additional common shares so issued constituted seven percent of the common shares then outstanding. As a result, the shares of corporation *N* owned by corporation *M* after the recapitalization constituted 93 percent of the outstanding common stock and 100 percent of the outstanding preferred stock.

Corporation *M* distributed all of the common stock and preferred stock of corporation *N* owned by it to the group of dissatisfied stockholders in exchange for all of their stock of corporation *M*. Such group thereby acquired control of corporation *N* and continued the operation of its business under their management. Corporation *M* continued the active conduct of its business under the separate ownership and management of its remaining shareholders.

Section 355(a) of the Internal Revenue Code of 1954 provides, in part, that if a corporation distributes to its shareholders, with respect to its stock, solely the stock of a corporation which it controlled immediately before the distribution, and the transaction is not used principally as a device for the distribution of earnings and profits and the requirements of subsection (b) (relating to active businesses) are satisfied, then no gain or loss shall be recognized to such shareholder. Subsection (b) provides that the controlled corporation and the distributing corporation must be actively engaged in a trade or business for a five-year period ending on the date of distribution. It is further

provided therein that the trade or business cannot have been acquired within the five-year period and that the control of the corporation which conducts the trade or business cannot have been acquired within the five-year period unless the provisions of subparagraph (D) of subsection 355(b) are complied with.

Section 355(b)(2)(D) provides as follows:

> (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—
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> * * * * * * *
>
> (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.

For purposes of section 355, the term "control," as defined in section 368(c), "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."

Although corporation *M* owned over 80 percent of the voting common stock of corporation *N* throughout the entire 5-year period ending on the date of the distribution of the *N* stock, it owned only 12 percent of the nonvoting preferred stock of corporation *N* from the beginning of such period until the consummation of the recapitalization of corporation *N*, when the preferred shares owned by it became the only nonvoting shares of corporation *N* outstanding. Thus, corporation *M* acquired control of corporation *N* during the said 5-year period, but only by reason of such recapitalization, combined with acquisitions of *N* stock before the beginning of the 5-year period. However, since the recapitalization of corporation *N* constituted a reorganization within the meaning of section 368(a)(1)(E) of the Code, and the exchanges made by the preferred stockholders in pursuance of such reorganization were nontaxable exchanges under the provisions of section 354(a)(1), control of corporation *N* was acquired by corporation *M* in a manner permitted by section 355(b)(2)(D)(ii).

Accordingly, it is held that, by reason of the provisions of section 355 (a) (1) of the Code, no gain or loss is recognized to those stockholders, who received the common stock and preferred stock of corporation *N*, as a result of the distribution of such stock to them in exchange for their stock of corporation *M*. The basis of the common stock and preferred stock of corporation *N* received by such stockholders is the same in their hands as their adjusted basis for the stock of corporation *M* exchanged therefor (section 358(a)(1) of the Code). No gain or loss is recognized to the stockholders of corporation *M* who continued to hold their stock of that corporation, or to either corporation *M* or corporation *N* as a result of the distribution.

(Also Sections 301, 316; 1.301–1, 1.316–1.) Rev. Rul. 56–227

A domestic corporation which is in the construction business transferred part of its assets to a newly formed foreign corporation in exchange for all of the stock of the latter and, in return, distributed such stock to its shareholders. *Held*, such distribution to the shareholders is not within the purview of the nontaxable provisions of section 355 of the Internal Revenue Code of 1954, since there is no separation of existing businesses, but rather the commencement of a new venture. Accordingly, the activities of the new corporation did not constitute a trade or business throughout the five-year period ending on the date of the distribution.

Advice has been requested as to the tax consequences of a distribution of stock of a new foreign corporation to the stockholders of a domestic corporation under the following circumstances:

The domestic corporation is engaged in the general contracting and construction business. Its capital stock consists of preferred and common stock. The corporation has operated, and is operating, in various locations throughout the United States. For valid business reasons, the domestic corporation organized a new foreign corporation and transferred to the latter a portion of its assets in exchange for all of the latter's capital stock, which was distributed pro rata to its shareholders. This transaction was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes under section 367 of the Internal Revenue Code of 1954, and it resulted in no gain or loss to the domestic corporation under section 351 of such Code.

The specific question presented is the treatment of the distribution by the domestic corporation of the stock of the new corporation to its stockholders.

Section 355 of the Code provides that under certain conditions a corporation may distribute to its shareholders the stock of a corporation which it controls immediately before the distribution without the recognition of gain or loss to the shareholders. One of the conditions is that the requirements of section 355(b) of the Code, relating to "active businesses," are satisfied. It is provided (section 355 (b)(1)(A)) that where the distributing corporation has assets other than stock of the controlled corporation, then both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business. Under section 355(b)(2)(B), before a corporation can be considered to be engaged in the active conduct of a trade or business after the distribution, such trade or business must have been actively conducted throughout the five-year period ending on the date of the distribution. See section 1.355–4 of the Income Tax Regulations.

The above section contemplates the separation, without the recognition of gain or loss to the shareholders and security holders, of two or more existing businesses formerly operated by a single corporation. See section 1.355–1(a) of the Income Tax Regulations. In the instant case there was no separation of existing businesses. Rather, a new venture was undertaken by a new corporation in a new territory and in a different country. Therefore, the business operation of the new foreign corporation did not constitute a trade or business prior to the

time the business activities were begun by such corporation. See example 9, section 1.355–1(d) of the Income Tax Regulations. As a result, the activities of the new corporation did not constitute such trade or business actively conducted throughout the five-year period ending on the date of the distribution.

Accordingly, the distribution by the domestic corporation of all of the stock of the new corporation to its stockholders constituted a distribution within the meaning of section 301 of the Code. The fair market value of the stock distributed is taxable as an ordinary dividend to the extent provided in section 316 of the 1954 Code.

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26 CFR 1.355–4: Active conduct of a trade or business. Rev. Rul. 56–266

(Also Sections 301, 316, 361, 368; 1.301–1, 1.316–1, 1.361–1, 1.368–2.)

Corporation *A* was engaged in the operation of a grocery business, a bakery business, and a creamery products business. It owned real estate, all of which was used in connection with the grocery business. Corporation *A* transferred the assets of the bakery business to new corporation *B*, transferred the assets of the creamery products business to new corporation *C*, and transferred the real estate to new corporation *R*, the transfer, in each case, being in exchange for all of the stock of the transferee corporation. The stocks of the new corporations were distributed to the stockholders of corporation *A*. *Held*, under section 355 of the Internal Revenue Code of 1954, no gain or loss is recognized to (and no amount is includible in the income of) the stockholders of corporation *A* as the result of the receipt by them of the stocks of corporations *B* and *C*. *Held further*, the distribution by corporation *A* of the stock of corporation *R* constituted a distribution of property to which section 301 applies.

The Internal Revenue Service has been requested to explain the application of section 355 of the Internal Revenue Code of 1954 in connection with the transaction herein set forth.

Corporation *A* had been engaged for over five years in the operation of a retail grocery chain, the manufacture and distribution of bakery products, and the production and distribution of creamery products.

Corporation *A* had also owned various parcels of real estate for over five years. It had no lease contracts with outside tenants. With the exception of two vacant lots, the real estate owned consisted of land with buildings thereon which were used for stores and offices connected with the grocery business. For these properties, corporation *A* had consistently charged itself rental in the sum of a certain percent of gross sales. The bakery and creamery products were manufactured and processed in plants separate from one another and from the real estate of the corporation.

Corporation *A* organized three new corporation (corporations *B*, *C*, and *R*). It transferred the assets of the bakery business to corporation *B*, transferred the assets of the creamery products business to corporation *C*, and transferred the real estate to corporation *R*, the transfer, in each case, being in exchange for all of the stock of the transferee corporation. The stocks issued by the new corporations

were distributed to the stockholders of corporation *A*, without the surrender of any of their stock of corporation *A*. The purpose of the transaction was to separate the various unrelated activities of corporation *A*, as it was believed, for a number of business reasons, that the activities could be operated more profitably separately. It is not contemplated that either corporation *A* or any of the new corporations will be liquidated or that the stockholders will sell their stock of any of the corporations.

The specific question presented is whether the receipt of the stocks of corporations *B*, *C*, and *R* resulted in the recognition of any gain to the stockholders of corporation *A*.

In general, the distribution of stock in a controlled corporation is nontaxable only if the specific requirements of section 355 of the Internal Revenue Code of 1954 are met. Among the requirements contained in section 355 is the requirement of section 355(b) that both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business after the distribution. This means that the trade or business must have been actively conducted throughout the five-year period ending on the distribution date, and that neither the trade or business nor the control of the controlled corporation was acquired within such five-year period by a purchase or other wholly or partly taxable transaction. The term "the active conduct of a trade or business" requires that there be a specific existing group of activities being carried on for the purpose of earning income or profit from such activities. In the instant case, the ownership of land and buildings which were used by the owner in the operation of a grocery chain did not represent the operation of a trade or business separate and apart from the grocery business. Moreover, see section 1.355–1(c) of the Income Tax Regulations.

Accordingly, it is held that the distribution of the stock of corporation *R* is a distribution to which section 301 of the Code applies. However, no gain or loss is recognized to corporation *A* as the result of the transfer of its real estate to corporation *R* in exchange for all of the stock of corporation *R*, and the basis of the assets acquired by corporation *R* is the same as it was in the hands of corporation *A*, under the provisions of sections 351 and 362 of the Code.

No gain or loss is recognized to corporation *A* as the result of the transfer of the assets of the bakery business and the creamery products business to corporations *B* and *C*, respectively, in exchange, in each case, for all the stock of the transferee (sections 368(a)(1)(D) and 361(a) of the Code), and the basis of the assets acquired by each new corporation is the same as it was in the hands of corporation *A* (section 362 of the Code). Under section 355 of the Code, no gain or loss is recognized to, and no amount is includible in the income of, the stockholders of corporation *A* as the result of the receipt by them of the stocks of corporations *B* and *C*. Proper allocation of the earnings and profits of corporation *A* should be made among it and corporations *B* and *C* under the provisions of section 312(i) of the Code for the purpose of determining the earnings and profits of each corporation available for distribution to its stockholders.

A corporation, owning and operating a bus service, organized a new corporation and transferred, solely in exchange for stock of the latter corporation, all its buses and other transportation equipment. Immediately, the original corporation distributed to its shareholders, without surrender of their stock, the stock of the new corporation. *Held*, such distribution does not qualify as a tax-free distribution within the purview of section 355 of the Internal Revenue Code of 1954, since the activities of the original corporation constituted an integral part of only one enterprise. Hence, the distribution of such new stock is treated as a dividend under the provisions of section 301 of the Code.

Advice has been requested as to the tax effects of a transfer by a corporation of certain commercial vehicles to a new corporation in exchange for all the capital stock of the new corporation, the new stock being distributed to the stockholders of the original corporation.

A certain corporation had been engaged in the active conduct of operating a bus service within a certain state. It also operates terminal facilities which are located upon real estate which it owns or rents. The corporation is subject to the Public Service Commission in that state. Occassionally, it leased buses on a charter basis to other bus operators for various periods of time.

The corporation desired to engage extensively in the general business of leasing buses and other transportation equipment to various independent small bus operators. From a banking standpoint, a divorce is essential to this type of business because of accident hazards of an operating company.

Accordingly, the corporation formed a new corporation transferring all buses and other transportation equipment, together with its cash depreciation fund and life insurance on the lives of its officers, solely in exchange for shares of the new corporation. Immediately following such exchange, the original corporation distributed to its shareholders on a share for share basis, without surrender of their stock, the stock of the new corporation. Assets retained by the original corporation consisted principally of cash, accounts receivable, materials and supplies, real estate, and equipment other than buses.

Following the transaction, the new corporation leased to the original corporation, and to various other small bus operators, buses and other transportation equipment. Developments in the bus business in recent years have made it economically desirable to furnish this type of equipment for rental service. Many small bus operators, by reason of the general decrease in bus business, are finding it difficult to purchase equipment outright or even on a time-payment basis.

Section 355 of the Internal Revenue Code of 1954 provides for the separation, without recognition of gain or loss to the shareholders and security holders, or two or more existing businesses formerly operated by a single corporation. This section applies only to the separation of existing businesses which have been in active operation for at least five years immediately prior to the distribution.

It appears, however, that prior to the formation of the new corporation in the instant case, the activities of the original corporation constituted integral parts of only one business and not two separate and distinct enterprises. Pursuant to the plan, the new corporation will

own buses and will lease them to the first corporation and others, and the first corporation will operate the buses it leases from the new corporation in connection with the conduct of its regular bus service.

It is recognized by the Internal Revenue Service that the owning and leasing of buses to others for operation and the operation of a bus service by the use of leased lines could constitute separate and distinct businesses. However, in the instant case, in order for the distribution of the stock of the new corporation to qualify as a transaction coming under the provisions of section 355 of the Code, it must be shown that the original corporation was, and had been during the past five years, engaged in the two types of businesses described.

In view of the foregoing, it is held that the distribution of the stock of the new corporation to the stockholders of the original corporation does not qualify as a transaction within the purview of section 355 of the Code.

The transfer of assets to the new corporation did not constitute a reorganization within the meaning of section 368(a)(1)(D) of the Code because the transaction did not qualify under section 355, for the reasons explained above, or under section 354(a)(1) because of the provisions of section 354(b). However, there is no recognizable gain or loss to either of the corporations involved because the transaction comes within the meaning of section 351 of the Code. The distribution of the stock of the new corporation constituted a dividend to the recipients under the provisions of section 301 of the Code to the extent provided in section 316 thereof.

SECTION 356.—RECEIPT OF ADDITIONAL CONSIDERATION

26 CFR 1.356–1: Receipt of additional consideration in connection with an exchange. (Also Sections 302, 354, 358, 368; 1.302–1, 1.354–1, 1.358–1, 1.368–1.) — Rev. Rul. 56–179

> Where a corporation gives its first preference stockholders an option to exchange their shares for common stock, debenture bonds, and accrued dividends in cash, in preference to converting such preference stock into common stock or to receiving a stated redemption price plus accrued dividends, the gain will be recognized to the extent of the fair market value of the bonds and the cash. Such gains will be taxable as a dividend to the extent of the amount of the accrued dividends, and the balance of the gain so recognized will be treated as a distribution in exchange for the stock under section 356 of the Internal Revenue Code of 1954.

Advice has been requested as to the Federal income tax consequences of a proposed recapitalization of a corporation in which certain amounts of first preference stock will be converted into common stock, certain amounts exchanged for common stock, bonds and accrued dividends in cash, and certain amounts redeemed for $100 per share plus accrued dividends.

Following a bankruptcy proceeding in 1941, the corporation issued certain preferred stock to its bondholders and general creditors. In 1951, at a time when unpaid and cumulative dividends had accrued on the preferred stock, the stock was replaced with two new issues,

i. e., first preference stock and second preference stock. For each share of the old preferred stock plus dividend arrearages, the shareholders received one share of first and one share of second preference stock. Following this recapitalization, the financial condition of the corporation improved and early in 1955 the corporation redeemed its second preference stock for cash.

The first preference stock is callable under the terms of its issuance at $100 per share plus accrued dividends. Each first preference shareholder has the right to convert each share of his first preference stock into seven shares of common stock at any time up to the close of business on the second day before the redemption date. Dividends are not in arrears on the first preference stock. On a certain date the preference stock was quoted at 109¾ dollars and the common stock at 15⅜ dollars on the American Stock Exchange.

It is now proposed to redeem all the first preference stock. However, it is believed that many shareholders would convert their first preference shares into common shares rather than accept the cash redemption price. In order to avoid the issuance of a large number of new common shares, the preference shareholders will be given an additional option. Each shareholder who does not convert his first preference stock into common stock will receive for each share not so converted, in addition to cash of $100 plus accrued dividends, a nontransferable right to purchase from the corporation, during a specified period after the date of redemption, a unit consisting of a $100 debenture and one share of common stock, at a price of $100 per unit. The shareholder may exercise this right either by paying $100 cash or by assigning to the corporation the right to receive the $100 redemption price.

Prior to the redemption, 56 percent of the preference stock was held by persons who held no common stock, and 82 percent of the common stock was held by persons who held no preference stock. Only one of the shareholders holding over 0.4 percent of the preference stock held over one percent of the common stock, and no substantial amount of preference stock was held by record holders who held substantially proportionate amounts of common stock.

Section 354 of the Internal Revenue Code of 1954 provides in part:

> (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.

Pertaining to the receipt of additional consideration, section 356 of the Code states in part:

> (a) GAIN ON EXCHANGES.—
> (1) RECOGNITION OF GAIN.—If—
> "(A) section 354 * * * 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 * * * 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.

Defining a corporate reorganization, section 368 of the Code provides in part:

(a) REORGANIZATION.—
(1) IN GENERAL.—* * * the term "reorganization" means—

* * * * * * *

(E) a recapitalization; * * *.

Accordingly, it is held as follows:

(1) Where the shareholder exercises his right to convert his first preference stock into common stock, no gain or loss will be recognized under sections 368(a)(1)(E) and 354 of the Code, and under the provisions of section 358 of the Code, the basis of the common stock received will be the same as the cost or other basis of the first preference exchanged therefor.

(2) Gain realized by the shareholder who exchanges first preference stock for bonds and common stock, plus cash equivalent to the amount of accrued dividends on the first preference stock, will be recognized but will be limited to the amount of money and the fair market value of the bonds received, and no loss will be recognized (sections 368(a)(1)(E) and 356 of the Code). The gain recognized will be treated as a dividend to the extent of the accrued dividend in such amount as is not in excess of the shareholder's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, under the provisions of section 356(a)(2) of the Code. The remainder of the gain recognized will be treated as a gain from the exchange of property, subject to the applicable provisions of subchapter P of Chapter 1 of the Code. Under section 358 of the Code, the basis of the common stock received will be the same as the basis of the first preference stock exchanged therefor, decreased by the fair market value of the bonds and the amount of money received and increased by the amount of gain recognized. The basis of the bonds will be their fair market value. The effect of the exchange will be the same whether the shareholder acquires the bonds and common stock by a cash payment or by assignment of the $100 per share redemption price of his first preference stock.

(3) The total amount received by a shareholder whose first preference stock is redeemed at $100 per share plus accrued dividends will be treated as having been received in redemption of the stock under section 317 of the Code. Such redemption, which will not be a distribution equivalent to a dividend, will be treated as a distribution in payment in exchange for the stock under sections 302(b)(1) and 302(a) of the Code. Gain or loss will be realized by the shareholders to the extent of the difference between the cost or other basis, for Federal income tax purposes, of each share of the first preference stock surrendered and the total amount received therefor. Such gain or loss will be subject to the provisions of Part I of subchapter O and of subchapter P of Chapter 1 of the Code.

(Also Sections 301, 354, 358, 368; 1.301–1, 1.354–1, 1.358–1, 1.368–1. Rev. Rul. 56–184

Where an agreement between two corporations in connection with a nontaxable reorganization under sections 368(a)(1)(B) and 354(a)(1) of the Internal Revenue Code of 1954, provides that the corporation, whose stock is being acquired, may pay cash dividends to its stockholders to the extent of the net earnings of such corporation for a specified period of time prior to the exchange, the entire amount of any cash distribution to such shareholders is taxable as a dividend under section 301 of such Code and not as cash received as a part of the reorganization under section 356 of the 1954 Code.

Advice has been requested as to the Federal income tax consequences of an acquisition by one corporation of all the outstanding stock of another corporation under the circumstances described below.

Y corporation is engaged in the business of manufacturing metal products. It has outstanding special preferred participating stock, first and second preferred stock, and common stock. Only the special preferred participating stock is non-voting.

Z corporation desired to control *Y* corporation inasmuch as the business of the latter complemented *Z*'s light industrial machinery business and geographically fitted its entire system. To that end, *Z*, pursuant to a plan of reorganization, acquired all of the outstanding stocks of *Y* by issuing in exchange therefor certain shares of voting common stock of *Z*. The number of shares of *Z* stock issued in the exchange was based on the value of *Y*'s assets as of a specified date. The earnings of *Y* from that date to the date of closing were distributed to the share holders of *Y* as dividends prior to the exchange.

Section 368 of the Internal Revenue Code of 1954 provides, in part, as follows:

(a) REORGANIZATION.—
(1) IN GENERAL.— * * * the term "reorganization" means—

* * * * * * *

(B) the acquisition by one corporation, in exchange solely for all or part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation * * *.

As to the effect on shareholders in a reorganization, section 354 of the Code reads in part:

(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.

The exchanges of the *Y* stocks solely for voting stock of *Z* fulfills the requirements of these sections of the Code.

Therefore, the only specific question is whether the receipt of cash dividends by the stockholders of *Y* corporation is within the purview of section 356 of the Code which provides in part:

(a) GAIN ON EXCHANGES.—
(1) RECOGNITION OF GAIN.—If—
(A) section 354 * * * 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 * * * 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.

In the dividend transaction here involved, section 356 of such Code is not applicable because the cash distributed is not cash received in connection with an exchange of stock. If it were, section 368(a)(1)(B) of the Code, quoted above, would not apply because that section is applicable only if voting stock of the acquiring corporation is the sole consideration given for the stock acquired.

Accordingly, no gain or loss is recognized to the shareholders of *Y* corporation upon the exchange of the stock held by them solely for voting common stock of *Z* corporation; and the basis of the *Z* stock acquired by the former shareholders of *Y* is the same as the basis of *Y* stock exchanged therefor. The entire amount of the cash distribution by *Y* to its shareholders is treated as taxable dividends.

Rev. Rul. 56–220

Where a statutory merger was effectuated under section 368(a)(1)(A) of the Internal Revenue Code of 1954, the amount distributed in cash to the shareholder of the absorbed corporation in the exchange had the effect of a distribution of a dividend within the purview of section 356(a)(2) of the Code.

Advice has been requested with respect to the tax effect of cash distributed in connection with a statutory merger (reorganization) under section 368(a)(1)(A) of the Internal Revenue Code of 1954 involving two banks.

Pursuant to a plan of reorganization, *Y* bank merged into *Z* bank. In consideration for the net assets of the absorbed bank, the acquiring bank made available to the stockholders of the former shares of its capital stock plus cash. The stockholders of *Y* bank surrendered the stock of their corporation in exchange for stock of *Z* bank and cash.

The cash was paid by *Z* bank from a special trust set up by it for that purpose in its trust department. Such money was paid directly to the individual stockholders of *Y* bank and did not pass through the *Y* corporation. It was not part of the assets which were transferred to *Z* bank.

When the negotiations for the merger first began, it was the intention of the officers of both banks that the assets of *Y* be acquired by *Z* solely in exchange for stock of the latter bank. However, after determining the relative values of the stock of the two banks, it was found that the exchange of stock of the *Y* bank for stock of the *Z* bank on the basis of the values agreed upon would result in odd fractional shares of stock which would not be practicable to issue. The *Z* bank would not consent to issue fractional shares on any basis, but insisted on whole shares, plus cash. Moreover, *Z* bank did not desire to give the stockholders of *Y* such a large common stock ownership in the surviving corporation. Finally, the officers of both banks agreed to the exchange of stock of the *Y* bank for stock of the *Z* bank on a whole share basis, plus cash.

Section 354 of the Internal Revenue Code of 1954 provides in part:

(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.

Also, section 356 of such Code states in part:

(a) GAIN ON EXCHANGES.—
(1) RECOGNITION OF GAIN.—If—
(A) section 354 * * * 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 * * * 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.

The question at issue is whether the distribution of cash had the effect of the distribution of a dividend within the meaning of section 356(a)(2) of the Code. In *Commissioner* v. *Edward T. Bedford Estates, et al.*, 325 U. S. 283, Ct. D. 1641, C. B. 1945, 357, the Supreme Court of the United States took the position that where preferred stock is exchanged for new preferred stock, common stock and cash, the cash received was taxable as an ordinary dividend under the provisions of section 112(c)(2) of the Revenue Act of 1936. That provision corresponds to section 356(a)(2) of the 1954 Code. It is stated in the Bedford opinion that under section 115(a) (section 301 of the 1954 Code) a distribution out of accumulated earnings and profits is a "dividend," thus confirming the conclusion that a distribution of earnings and profits has the "effect of the distribution of a taxable dividend" under section 112(c)(2). It is specifically stated in the opinion that:

> It has been ruled in a series of cases that where the stock of one corporation was exchanged for the stock of another and cash then distributed, such distributions out of earnings and profits had the effect of a distribution of a taxable dividend under section 112(c)(2). (*Commissioner* v. *Owens*, 69 Fed. (2d) 597; *Commissioner* v. *Forhan Realty Corporation*, 75 Fed. (2d) 268; *Rose* v. *Little Investment Company*, 86 Fed. (2d) 50; *Love* v. *Commissioner*, 113 Fed. (2d) 236; *Campbell* v. *United States*, 144 Fed. (2d) 177).

To the same effect is the United States Board of Tax Appeals decision in the case of *George Woodward* v. *Commissioner*, 23 B. T. A. 1259.

Accordingly, it is held that the cash received in the exchange had the effect of the distribution of a dividend under the provisions of section 356(a)(2) of the Code. Therefore, the portion of the gain recognized which was not in excess of each distributee's ratable share of the undistributed earnings and profits of the *Y* bank accumulated after February 28, 1913, is treated as a dividend to *Y*'s stockholders. The remainder, if any, of the gain recognized is treated as gain from the exchange of property.

SECTION 358.—BASIS TO DISTRIBUTEES

26 CFR 1.358–1: Basis to distributees.

Common stock and debenture bonds received in an exchange for first preference stock. See Rev. Rul. 56–179, page 187.

The basis to stockholders in exchange pursuant to a reorganization. See Rev. Rul. 56–184, page 190.

SUBPART C.—EFFECTS ON CORPORATION

SECTION 361.—NONRECOGNITION OF GAIN OR LOSS TO CORPORATIONS

26 CFR 1.361–1: Nonrecognition of gain or loss to corporations.

The transfer by a corporation of assets of two new corporations in exchange for stock of such new corporations. See Rev. Rul. 56–266, page 184.

SUBPART D.—SPECIAL RULE; DEFINITIONS

SECTION 368.—DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS

26 CFR 1.368–1: Purpose and scope of exception of reorganization exchanges.

A merger between two corporations under certain circumstances. See Rev. Rul. 56–116, page 164.

Exchanges of new stock for old stock in the same corporation. See Rev. Rul. 56–117, page 180.

A recapitalization of a corporation. See Rev. Rul. 56–179, page 187.

An acquisition by one corporation in exchange for stock of another corporation. See Rev. Rul. 56–184, page 190.

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26 CFR 1.368–2: Definition of terms.

A change of capital structure by a corporation pursuant to a plan of reorganization. See Rev. Rul. 56–223, page 162.

"Spin-offs" from grocery chain. See Rev. Rul. 56–266, page 184.

PART V.—CARRYOVERS

SECTION 381.—CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS

Earnings and profits of an old corporation transferred to a new corporation. See Rev. Rul. 56–212, page 170.

SUBCHAPTER D.—DEFERRED COMPENSATION, ETC.

PART I.—PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

SECTION 401.—QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS

Rev. Rul. 56–213

The qualification of an employees' retirement plan, under section 401(a) of the Internal Revenue Code of 1954, and the exemption from tax, under section 501(a) of the Code, of the trust forming a part thereof, will not be adversely affected when participants, who are separated from the plan because of not meeting minimum work period requirements or termination of employment, are granted an annuity or a cash settlement under the terms of the plan and later meet the minimum work period requirements or are re-employed and, as a result, are reinstated as participants in the plan, provided the terms of the plan are uniformly applied and the full actuarial equivalent of the amount already vested in the participants is deducted from the amount of the pension or other settlement to be paid under the plan as a result of the service rendered after the reinstatement of the participants.

Advice has been requested whether the qualification of an employees' retirement plan, under section 401(a) of the Internal Revenue Code of 1954, and the exemption from tax, under section 501(a) of the Code, of the trust forming a part thereof, will be adversely affected if a participant, who has been separated from the plan because of not meeting minimum work period requirements or termination of service, has been granted an annuity or cash settlement under the plan and later meets such requirements, or is re-employed and, as a result, is reinstated as a participant in the plan.

The *M* company established an employees' retirement plan the entire costs of which are paid by the company. Any regular full-time employee who has been in the employ of the company for five years is eligible for participation in the plan if he is under the normal retirement age of 65 years. The plan is held to qualify under section 401(a) of the Code and the trust forming a part thereof is exempt from tax under section 501(a) of the Code.

Under the terms of the plan if, for any reason other than death or disability, an employee terminates his employment before he has completed five years as a member of the plan, he shall have no rights under the plan. After five or more years as a participant, if (1) at the time his employment is terminated the employee is not more than ten years

from his normal retirement date, he shall be vested with only the company's payment allocated for his benefit for each prior year of participation, or, if (2) the employee is more than ten years from his normal retirement date, he shall be vested with an amount equal to the lesser of (a) the sum of the company's payments allocated for his benefit for each prior year of participation or (b) a percentage of his average basic earnings, which percentage shall be the sum of (i) one percent for each year of employment prior to becoming a participant in the plan plus (ii) four percent for each year of participation as a member of the plan. Amounts so vested are payable as retirement income beginning on his normal retirement date or, at the option of the employee, he may elect to receive a cash payment in lieu of all or any part of his retirement income.

The plan also provides that if a terminated employee is subsequently re-employed prior to normal retirement date, he shall be considered a new employee for purposes of the plan except that his retirement benefits as a new member shall be reduced by any benefits vested in him on account of his previous participation in the plan.

The question is raised whether the plan would continue to meet the requirements of section 401(a) of the Code if employees were subsequently reinstated to membership in the plan after their eligibility for participation had terminated in the following circumstances:

1. The employee's eligibility for participation had been terminated under the rules relating to minimum work periods and the employee had elected and been granted either an immediate annuity or a cash payment in lieu thereof.
2. The employee's eligibility was similarly terminated and, after re-employment, he requested and was granted either an immediate annuity or a cash payment in lieu of an annuity with respect to his period of prior service.
3. The employee's service was fully terminated by resignation or by discharge (as compared to the case where under the rules relating to minimum work periods he was no longer eligible) and he requested and was granted either an immediate annuity or cash in lieu thereof.

It is held, that, if the terms of the plan are uniformly applied and the full actuarial equivalent of the amount already vested in the participant is deducted from the amount of the pension to be paid as a result of service rendered after the reinstatment of the employee, the qualification of the plan, under section 401(a) of the Code, and the exemption from tax, under section 501(a) of the Code, of the trust forming a part thereof, will not be adversely affected by any reinstatements to active participation in the plan.

Requirements to be met when a pension trust is established for an association of doctors. See Rev. Rul. 56–23, page 598.

Qualification of a group trust created for the purpose of investment of funds of various employee benefit trusts forming a part of qualified employee pension or profit-sharing plans. See Rev. Rul. 56–267, page 206.

Authority delegated to District Directors to issue determination letters. See Rev. Proc. 56–8, page 1024.

Procedure as to determinations of the qualification of pension, annuity, profit-sharing, and stock bonus plans and the status for exemption of related trusts. See Rev. Proc. 56–12, page 1029.

SECTION 402.—TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST

Rev. Rul. 56–214

An employee who, for any reason, terminates his participation in an employees' profit-sharing plan and trust, qualified under section 401(a) of the Internal Revenue Code of 1954 for exemption from tax under section 501(a) of the 1954 Code, but who continues his employment with his employer, is not deemed to have been separated from the service within the purview of section 402(a)(2) of the 1954 Code. Therefore, long-term capital gain treatment will not be accorded a lump-sum distribution of the total amount standing to the employee's credit in the trust.

Advice has been requested whether continuation in the service of the employer by employees who no longer participate in the profits of the employer, under the employer's profit-sharing plan, precludes such employees from availing themselves of the long-term capital gain provisions of section 402(a)(2) of the Internal Revenue Code of 1954 (section 165(b) of the 1939 Code), with respect to lump-sum distributions made at the time of discontinuance of participation in the plan.

A profit-sharing plan and trust established by an employer, for the benefit of his employees, covers all employees with a stated minimum number of years of service. The plan provides that at the close of the year in which an employee reaches age 60, the employee retires from the plan or terminates his profit-sharing employment and is eligible for a lump-sum distribution of the total amount standing to his credit in the trust. Should the employee continue to work for the employer, after retiring from the plan at age 60, the employee's records indicate that he is no longer eligible for profit-sharing. The profit-sharing plan and trust have been held to be qualified, under section 401(a) of the 1954 Code (section 165(a) of the 1939 Code), for exemption from Federal income tax under section 501(a) of the 1954 Code (section 165(a) of the 1939 Code).

Section 402(a)(2) of the 1954 Code provides that 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 one taxable year of the distributee on account of the employee's death or other separation from the service, or on account of the employee's death after separation from service, the amount of such distribution, to the extent exceeding the amounts contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months.

Section 402(a)(3)(C) defines the term "total distributions payable" as meaning 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.

An employee, in order to obtain the benefit of the long-term capital gain provision of section 402(a)(2) of the 1954 Code, must have completely severed his employment relationship with the employer at the time the distributions are received by him, for otherwise the distributions cannot be said to have been received on account of the employee's separation from the service. See *Frank B. Fry et al.* v. *Commissioner*, 19 T. C. 461, affirmed, 205 Fed. (2d) 517, in which it was held that the taxpayer's continued receipt of his regular salary required the conclusion that he had not severed his connection with his employer and, therefore, was not entitled to the benefit of the capital gain treatment.

Accordingly, it is held that an employee who, for any reason, terminates his participation in an employees' profit-sharing plan and trust, qualified under section 401(a) of the 1954 Code for exemption from tax under section 501(a) of the 1954 Code, but who continues his employment with his employer whether under his previous employment agreement or another employment agreement, is not deemed to have been separated from the service, within the purview of section 402(a)(2) of the 1954 Code. Therefore, the benefit of long-term capital gain treatment will not be accorded a lump-sum distribution of the total amount standing to the employee's credit in the trust in such a case.

Determination of amounts distributed, under a trusteed employees' pension plan, which were not includible in gross income in the case of a resident citizen of the United States who had been employed as a bona fide resident of a foreign country and who had retired prior to January 1, 1951. See Rev. Rul. 56–123, page 60.

SECTION 403.—TAXATION OF EMPLOYEE ANNUITIES

Determination of amounts paid, under an employees' annuity contract, which were not includible in gross income of a resident citizen of the United States who had been employed as a bona fide resident of a foreign country and who retired prior to January 1, 1951. See Rev. Rul. 56–123, page 60.

SUBCHAPTER E.—ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

PART II.—METHODS OF ACCOUNTING

SUBPART B.—TAXABLE YEAR FOR WHICH ITEMS OF GROSS INCOME INCLUDED

SECTION 453.—INSTALLMENT METHOD

Rev. Rul. 56–20

Under the provisions of a contract of sale, the taxpayer agreed to sell certain real estate for x dollars, a portion of which was payable

upon execution of the agreement and the balance payable in cash upon closing of the transaction, with an option reserved by the seller of requiring the buyer to pay a portion in cash and executing notes for the balance. The full amount of the unpaid balance in cash was accepted by the seller at the time the sale was consummated. *Held*, the acceptance of the full balance in cash determined the manner in which the sale was consummated for Federal income tax purposes. Therefore, since the entire proceeds were paid in cash, the seller may not alter the form of the sale so as to permit him to report the gain realized from the sale of the realty on the installment method.

Dividends paid on shares of stock sold and held in trust applied as payments against interest and principal of a promissory note given for the purchase of the stock. See Rev. Rul. 56–153, page 166.

Installment gain from collections on promissory note sold to subsidiary by parent corporation. See Rev. Rul. 56–186, page 441.

SUBCHAPTER F.—EXEMPT ORGANIZATIONS

PART I.—GENERAL RULE

SECTION 501.—EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

Rev. Rul. 56–13

An organization which raises funds to be used in travel and other activities to interview and persuade prospective students with outstanding athletic ability to attend a particular university, and which is not an integral part of such institution, is not exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 as an educational organization.

Advice has been requested whether an organization which raises funds to be used principally in travel and other activities necessary to interview and persuade prospective students with outstanding athletic ability to attend a particular university, and which is not an integral part of such institution, is exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 as an educational organization.

The instant organization was incorporated as a nonprofit, charitable and educational organization for the purpose of promoting the education of young men and women interested in college athletics and in receiving a college education. Members of the organization hold meetings in their respective towns to which interested athletes are invited to hear addresses and discussions by university coaches and officials. During the year, representatives of the university make trips throughout the area to interview prospective students and to endeavor to induce them to attend the university.

The travel expenses of these individuals, including train and airplane tickets, hotel accommodations, meals, entertainment, etc., and the travel expenses of prospective athletes when brought to the university, and other items incident to travel and entertainment, are paid by the organization. The university does not in any way finance or supervise the activities of the organization.

Section 501(c)(3) of the Code of 1954, which corresponds to section 101(6) of the Code of 1939, provides for the exemption of:

> Corporations * * * or foundations, organized and operated exclusively for religious * * * or educational purposes * * * no part of the net earnings of which inures to the benefit of any private shareholder or individual * * *.

The instant organization is not an integral part of the university and is not financed or supervised by such institution. Its principal activity is to persuade students of outstanding athletic ability to attend the university. These activities are not properly classifiable as exclusively educational within the purview of section 501(c)(3), *supra*.

Accordingly, it is held that an organization which raises funds to be used in travel and other activities to interview and persuade prospective students with outstanding athletic ability to attend a particular university, and which is not an integral part of such institution, is not exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 as an educational organization.

Rev. Rul. 56–65

> A local organization whose principal activity consists of furnishing particular information and specialized individual service to its individual members engaged in a particular industry, through publications and other means to effect economies in the operation of their individual businesses is performing particular services for individual persons. Such organization, therefore, is not entitled to exemption from Federal income tax under section 501(c)(6) of the Internal Revenue Code of 1954 as a business league even though it performs functions which are of benefit to the particular industry and the public generally.

Advice has been requested whether a local organization, whose principal activity consists of furnishing information to and advertising the products of its members engaged in a particular industry through publications and other means, qualifies for exemption from Federal income tax under section 501(c)(6) of the Internal Revenue Code of 1954 as a business league under the circumstances set forth below.

The instant organization, whose membership is restricted to individuals engaged in the building engineering construction business, was incorporated for the purpose of promoting, by educational means, better relations between private owners and public bodies; maintaining, by educational means, high professional standards; combating unfair practices; promoting efficiency among contractors; supporting contractors in efforts to rectify conditions of unsatisfactory character; encouraging the use of methods of contracting for work which relieve the contractor of improper risks; and encouraging sound business methods tending to raise the standing of contractors generally in the

business world. Activities consist of the maintenance of plan rooms for the convenience of members. Plans and specifications for local construction projects, together with the names of general contractors bidding on specific projects, are filed in the plan rooms by various governmental construction agencies. Plans and specifications are also filed by leading architects and engineers. Rooms are open daily for the use of members and the members may reserve plans and specifications for use overnight or over the week-end. A publication is issued to members twice weekly containing information obtained direct from governmental agencies, and from architects and engineers, with respect to projects available for bids and correct lists of bidders, together with their addresses and telephone numbers. The publication contains reports on contract awards and materials purchased by general contractors and serves as the spokesman for the local construction industry. It also serves as an advertising medium for the products and services being made available to the industry. Copies of the publication are mailed to cooperating architects, engineers, and Federal agencies without charge. At frequent intervals, corrected and revised lists of all buyers in general contracting organizations in the local area are published. A labor committee is maintained within the organization to settle labor disputes by arbitration, to prevent strikes and lockouts, promote steadiness of employment in the skilled building trades, and to assure just and equitable treatment in relations with employers in the building trades. In connection with this activity, a handbook on working rules and wage rates is published with supplementary pages and replacements necessitated by changes in working rules or wage rates. As a further service, lists of sub-contractors and material vendors are furnished members showing specific projects and from whom bids and quotations may be obtained. An official directory and guide lists members, cooperating architects and engineers, giving addresses and telephone numbers.

Income is derived by the organization principally from membership dues and advertising, and funds are expended for salaries and operating expenses.

Section 501(c) of the Internal Revenue Code of 1954 describes certain organizations exempt from income tax under section 501(a) and reads, in part, as follows:

> (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.

Section 39.101(7)–1 of Regulations 118, made applicable hereto by virtue of Treasury Decision 6091, C. B. 1954–2, 47, provides that:

> A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. * * *.

The organization in the instant case has established that it performs functions which are of benefit to the building industry, the general public, State and Federal Governments, and their agencies. Also, the facts indicate that its purposes and activities carry many of the attributes normally found in business leagues entitled to ex-

emption under section 501(c). However, they do not support a conclusion that the principal activity of this organization is directed to the improvement of business conditions of the building industry, as such, but indicate that the organization has been created and is primarily operated as a service to its individual members. For these reasons, consideration of all the facts in the case require the conclusion that the organization is primarily engaged in the performance of particular services for individual persons within the ambit of section 39.101(7)–1 of Regulation 118.

Accordingly, it is held that the instant organization is not entitled to exemption from Federal income tax under section 501(c)(6) of the Internal Revenue Code of 1954 as a business league.

Compare Revenue Ruling 54–442, C. B. 1954–2, 131, and Revenue Ruling 55–444, C. B. 1955–2, 258, in which organizations operated primarily to promote the interests of particular industries were held to be exempt from Federal taxation as business leagues, notwithstanding minor activities which resulted in benefits to individual members.

Rev. Rul. 56–84

An organization, operated primarily for the purpose of promoting, selling and handling the national advertising in its members' publications, is engaged in the performance of particular services for individual members as distinguished from activities for the improvemnt of the business conditions of its members as a whole and, therefore, is not entitled to exemption from Federal income tax as a business league.

Advice has been requested whether an organization operated in the manner described below is entitled to exemption from Federal income tax as a business league.

In the instant case, the purpose of the organization is to assist in the promotion and sale of advertising in publications owned and controlled by member cooperatives selling a specified product. The organization has authority to represent its members in the making of contracts or agreements with advertising agencies or advertisers for the mutual benefit of such members. The organization also engages in the compilation and dissemination of information with respect to the product of the cooperatives and the furnishing of services to the cooperatives and others in connection with the coordination, advancement and development of the product for the primary and mutual benefit of its members and their patrons.

Section 39.101(7)–1 of Regulations 118, made applicable by reason of Treasury Decision 6091, C. B. 1954–2, 47, provides that a business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.

It is apparent that the instant organization is operated primarily for the purpose of promoting, selling and handling the national advertising in its members' publications. Such activities constitute

the performance of particular services for the individual members as distinguished from activities for the improvement of the business conditions of its membership as a whole. Accordingly, such an organization is not entitled to exemption from Federal income tax as a business league under section 501 (c) (6) of the Internal Revenue Code of 1954.

(Also Section 170.) Rev. Rul. 56–138

A trust is organized and operated by an employer for the primary purpose of paying pensions to its retired employees. In addition, the trust also provides certain other benefits to selected employees or their beneficiaries, the selection of the recipients and the amounts paid being based on need and being solely within the discretion of an executive committee. *Held*, a trust organized and operated for the primary purpose of paying pensions to retired employees is not organized exclusively for charitable purposes within the intendment of section 501(c) (3) of the Internal Revenue Code of 1954 and, therefore, is not entitled to exemption from Federal income tax under section 501(a) of the Code. Contributions to such a trust are not considered to be charitable contributions and, therefore, are not deductible by the donors as charitable contributions under section 170 of the Code.

Rev. Rul. 56–185

Criteria or tests to be met in determining whether a hospital qualifies for exemption from Federal income tax under section 501(a) of the Internal Revenue Code of 1954 as an organization described in section 501(c) (3) thereof.

Advice has been requested concerning the criteria or tests to be met in determining whether a hospital can qualify for exemption from income tax as a public charitable organization.

Section 501(c) of the Internal Revenue Code of 1954 describes certain organizations exempt from income tax under section 501(a) and reads, in part, as follows:

> (3) Corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific * * * purposes, * * * and no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, 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.

The only ground upon which a hospital may be held to be exempt under section 501(c) (3) of the Code is that it is organized and operated primarily for educational, scientific or public charitable purposes. Usually, the ground for exemption is that it is organized and operated for public charitable purposes. The Supreme Court of the United States in *Helvering* v. *Susan D. Bliss et al.*, 293 U. S. 144, Ct. D. 884, C. B. XIII–2, 191 (1934), held that the provisions of law granting exemption of income devoted to charity are liberalizations of the law in the taxpayer's favor, were begotten from motives of public policy, and are not to be narrowly construed. Thus, in regard to hospitals and similar organizations, the Internal Revenue Service

takes the position that the term "charitable" in its legal sense and as it is used in section 501(c)(3) of the Code contemplates an implied public trust constituted for some public benefit, the income or beneficial interest of which may not inure to the benefit of any private shareholder or individual.

In order for a hospital to establish that it is exempt as a public charitable organization within the contemplation of section 501(c)(3), it must, among other things, show that it meets the following general requirements:

1. It must be organized as a nonprofit charitable organization for the purpose of operating a hospital for the care of the sick. A nonprofit hospital chartered only in general terms as a charitable corporation can meet the test as being organized exclusively for charitable purposes. See *Commissioner* v. *Battle Creek, Inc.* 126 Fed. (2d) 405.

2. It must be operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay. It is normal for hospitals to charge those able to pay for services rendered in order to meet the operating expenses of the institution, without denying medical care or treatment to others unable to pay. The fact that its charity record is relatively low is not conclusive that a hospital is not operated for charitable purposes to the full extent of its financial ability. It may furnish services at reduced rates which are below cost, and thereby render charity in that manner. It may also set aside earnings which it uses for improvements and additions to hospital facilities. It must not, however, refuse to accept patients in need of hospital care who cannot pay for such services. Furthermore, if it operates with the expectation of full payment from all those to whom it renders services, it does not dispense charity merely because some of its patients fail to pay for the services rendered.

3. It must not restrict the use of its facilities to a particular group of physicians and surgeons, such as a medical partnership or association, to the exclusion of all other qualified doctors. Such limitation on the use of hospital facilities is inconsistent with the public service concept inherent in section 501(c)(3) and the prohibition against the inurement of benefits to private shareholders or individuals. It is recognized, however, that in the operation of a hospital there must of necessity be some discretionary authority in the management to approve the qualifications of those applying for the use of the medical facilities. The size and nature of facilities may also make it necessary to impose limitations on the extent to which they may be made available to all reputable and competent physicians in the area.

4. Its net earnings must not inure directly or indirectly to the benefit of any private shareholder or individual. This includes the use by or benefit to its members of its earnings by way of a distribution of profits, the payment of excessive rents or excessive salaries, or the use of its facilities to serve their private interests. If provision is made in the bylaws for dividends, exemption will not be allowed even though no dividends have been declared. Exemption will not be defeated, however, merely because the share-

holders or members might possibly at some future date share in the assets upon dissolution in the absence of a case of mala fides where there appears to be a plan on the part of the shareholder or individual to acquire assets on the dissolution of the corporation.

A community hospital of the type supported partly by contributions from the general public and/or public grants from a city, county or state, normally meets the requirements of section 501(c)(3) as a public charitable organization. It is formed for the purpose of furnishing hospital facilities to all persons in the community at the lowest possible cost and necessarily accepts patients who are unable to pay for hospital facilities in order to retain the support of the community. A nominal charity record for a given period of time, in the absence of charitable demands of the community, will not affect its right to continued exemption. On the other hand, a hospital formed by one or more physicians in a community who may own the capital stock thereof or rent the hospital facilities to a corporation which they control requires careful study to determine whether it is being operated in part to serve their interest, directly or indirectly. See I. T. 2421, C. B. VII–2, 150 (1928).

A hospital formed to operate on a membership basis to provide, at fixed rates, prepaid hospitalization to its members is not a charitable organization within the meaning of section 501(c)(3) of the Code. Compare G. C. M. 22554, C. B. 1941–1, 243. But exemption will not be denied merely because the hospital maintains a prepayment plan, so long as such plan is available to all persons living in the area and so long as the hospital makes available its facilities to the indigent as well as to pay patients to the same extent as any other hospital not operated for profit.

A hospital which is organized as required by section 501(c)(3) of the Code, but which engages primarily in operations foreign to its stated purposes, cannot qualify as a charitable organization under that section. Conversely, a hospital, otherwise exempt, will not lose its exempt status by reason of engaging in operations unrelated to its stated purposes if such operations may be considered as merely incidental. Such a hospital will, however, be required to file an income tax return, Form 990–T, U. S. Exempt Organization Business Income Tax Return, if its gross income (included in computing unrelated business taxable income) for the taxable year is $1,000 or more.

Rev. Rul. 56–245

An organization formed to encourage better and more economical methods of raising fur bearing animals, to provide an orderly system for marketing the pelts of its members and to create a public demand for their products, and which carries out its purposes by furnishing members educational material on the breeding and raising of fur bearing animals and the marketing of pelts, procuring agreements from auction companies to market the products of its members and furnish them certain beneficial services in connection therewith, and conducting advertising to encourage the use of fur products, is exempt from Federal income tax under section 501(c)(5) of the Internal Revenue Code of 1954 as an agricultural organization.

Advice has been requested whether an organization composed of fur ranchers, which obtains agreements from auction companies for the marketing of products of its members and the furnishing of certain

services in connection therewith and advertises fur products produced by members, under the circumstances set forth below, qualifies as an agricultural organization under section 501(c)(5) of the Internal Revenue Code of 1954.

The instant organization was incorporated for the purpose of encouraging better and more economical methods of raising fur bearing animals, educating and protecting the interests of those engaged in breeding them, securing better results in grading, advertising and marketing breeding stocks and pelts, and engaging in any activity connected therewith. Membership is open to producers of certain fur bearing animals who agree to market their pelts through designated auction companies with which the organization has agreements. Under the agreements, the auction companies market pelts for members and furnish them certain services which include visits to their farms or ranches, holding pelts in storage, insuring pelts, marketing and stamping pelts with identifying marks, providing sales rooms, making loans to them under certain conditions, maintaining inventories, and announcing auction sales in trade papers. The receipts of the organization are derived from a percentage of sales of members' pelts which is withheld by the auction company by agreement. Its disbursements are for advertising, general educational programs and other operating expenses.

The organization furnishes members information on selling methods, marketing problems, consumer demands, and conditions and grades of products. It endeavors to create a public demand for their products by advertising in newspapers and magazines. The advertisements stress the desirable features of the product, but do not contain the names of the members. The organization does not engage in the marketing of products of its members or assume any responsibility in connection therewith. It has no net income which will inure to the benefit of any member (except upon dissolution of the organization).

Labor, agricultural, or horticultural organizations contemplated by section 501(c)(5) of the Internal Revenue Code of 1954, as being entitled to exemption from income taxation, are those which:

(1) Have no net income inuring to the benefit of any member;

(2) Are educational or instructive in character; and

(3) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

See Section 39.101(1)–1 of Regulations 118, made applicable to section 501(c)(5) of the Internal Revenue Code of 1954 by Treasury Decision 6091, C. B. 1954–2, 47.

Accordingly, since the instant organization, in obtaining for its members certain services for the economical and orderly marketing of their products and advertising to increase the public demand for their products, is engaged in improving the conditions of its members and the grade of their products and in developing a higher degree of efficiency in their occupations, and since it has no net income inuring to the benefit of any member, it is held to be exempt from Federal income tax under section 501(c)(5) of the Internal Revenue Code of 1954 as an agricultural organization.

(Also Section 401.) Rev. Rul. 56-267

Where, under certain specified conditions, separate tax-exempt trusts, forming parts of employers' qualified pension or profit-sharing plans, pool their funds in a group trust created to provide diversification of investments, the group trust may constitute a tax-exempt trust and the exempt status of the separate trusts will not be adversely affected.

Advice has been requested whether various individual employee benefit trusts, each of which forms a part of an employer's pension or profit-sharing plan for his employees, may, solely for purposes of diversifying their investments, pool some or all of their funds in a group trust without adversely affecting their status under sections 401(a) and 501(a) of the Internal Revenue Code of 1954, and whether such a group trust will itself be entitled to exemption from tax under the 1954 Code.

Many trusts, which individually form a part of an employer's pension of profit-sharing plan for employees, are "qualified" trusts within the meaning of section 401(a) of the 1954 Code, and are exempt from tax under section 501(a) thereof, are insufficient in size to permit a satisfactory diversification in the investment of their funds. In order to provide such diversification, a number of these trusts have been and are interested in pooling some or all of their funds, solely for investment purposes, in a group trust. A group trust or investment trust is to be created which, by incorporation, becomes a part of the pension or profit-sharing plan of each employer whose "qualified" trust invests funds in the group trust. The group trust declaration of trust provides (1) that no trust may become a participant therein without the consent of the trustee of the group trust, (2) that only funds received from a participating trust under an employer's plan which incorporates the group trust as a part thereof may be accepted and invested pursuant to the provisions of the declaration of trust, and (3) that only those trusts, which are "qualified" trusts within the meaning of section 401(a) and are exempt from tax under section 501(a) of the 1954 Code, shall be eligible to participate in the group trust.

The group trust declaration contains a provision prohibiting assignment by a participating trust of all or any part of its interest in the group trust, and also contains an affirmative provision satisfying the requirements of section 401(a)(2) of the 1954 Code. See section 39.165-2 of Regulations 118, made applicable herein by Treasury Decision 6091, C. B. 1954-2, 47.

The trustee of a participating trust may, from time to time, transfer to the group trust all or such part of the funds of the participating trust as such trustee may deem advisable. Such funds shall be commingled, for investment purposes, with the funds received from other participating trusts. Such trustee also may, from time to time, withdraw from the group trust all or such part of its interest in the group trust assets as the trustee may deem advisable.

Section 501(a) of the Code provides, in effect, that a trust described in section 401(a) shall be exempt from tax.

Section 401 of the Code provides, in part, as follows:

"(a) REQUIREMENTS FOR QUALIFICATION.—A trust created or organized in the United States and forming a 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 * * *."

By making contributions to a participating trust, which provides that from time to time amounts so contributed may be transferred to and from a specified group trust, the employer and any participating employees, in effect, make contributions to the group trust for purposes of section 401(a)(1) of the Code. The group trust is declared to be a part of the plan and the trust instruments creating both the participating and group trusts provide that amounts shall be transferred from one trust to the other at the direction of the trustee of the participating trust.

Accordingly, it is held that the status of individual trusts, which form a part of an employer's pension or profit-sharing plan for employees, are "qualified" trusts within the meaning of section 401(a) of the Internal Revenue Code of 1954, and are exempt from tax under section 501(a) of that Code, will not be affected by the pooling of their funds in a group trust created solely for the purpose of providing a satisfactory diversification of investments for the individual participating trusts, provided (1) that such group trust is itself adopted as a part of each employer's pension or profit-sharing plan, (2) that the group trust instrument expressly limits participation to pension and profit-sharing trusts which are exempt under section 501(a) by reason of qualifying under section 401(a) of the 1954 Code, (3) that the group trust instrument prohibits that part of its corpus or income which equitably belongs to any participating trust from being used for or diverted to any purposes other than for the exclusive benefit of the employees or their beneficiaries who are entitled to benefits under such participating trust, (4) that the group trust instrument prohibits assignment by a participating trust of any part of its equity or interest in the group trust, and (5) that the group trust is created or organized in the United States and is maintained at all times as a domestic trust in the United States. Under such circumstances, the group trust will also constitute a qualified trust under section 401(a) of the 1954 Code and will be exempt from tax under section 501(a) of that Code.

Status for purposes of the Federal Insurance Contributions Act taxes of services performed in connection with the unrelated activities of an organization exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954. See Rev. Rul. 56-188, page 485.

Acceptable form of statement to be filed by State Chartered credit unions claiming exemption from Federal income tax. See Rev. Proc. 56-2, page 1017.

Authority delegated to District Directors to issue determination letters. See Rev. Proc. 56-8, page 1024.

SECTION 511.—IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS

Taxability of certain brokerage commissions received and deposited to a special fund to be expended fcr public purposes. See Rev. Rul. 56-152, page 56.

PART III.—FARMERS' COOPERATIVES

SECTION 521.—EXEMPTION OF FARMERS' COOPERATIVES FROM TAX

Rev. Rul. 56-21

A farmers cooperative marketing and purchasing association otherwise exempt from taxation under section 521 of the Internal Revenue Code of 1954 will not be denied such exemption if a substantial part of its voting capital stock is held in trust by its membership committee for members of the association who are the beneficial owners thereof. Capital stock so held qualifies as stock "owned by producers who market their products or purchase their supplies and equipment through the association" within the intendment of section 521 of the 1954 Code.

Authority delegated to District Directors to issue determination letters. See Rev. Proc. 56-8, page 1024.

SUBCHAPTER G.—CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

PART I.—CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS

SECTION 534.—BURDEN OF PROOF

Procedures for the preparation and mailing of a notification letter with respect to the accumulated earnings tax. See Rev. Proc. 56-11, page 1028.

SUBCHAPTER I.—NATURAL RESOURCES

PART I.—DEDUCTIONS

SECTION 611.—ALLOWANCE OF DEDUCTION FOR DEPLETION

Rev. Rul. 56-105

Where the manner in which the deduction for depletion may be apportioned and allocated between the income beneficiaries and the trust is, under the terms of the trust instrument, within the sole discretion of the trustees, they may properly allocate all of the depletion deduction to the beneficiaries and retain none for the trust although a substantial portion of the income from the depletable assets is retained by the trust.

Advice has been requested whether a trustee may allocate the percentage depletion allowance between the trust and the beneficiaries in a manner other than on the basis of the trust income allocable to each.

Section 611(b)(3) of the Internal Revenue Code of 1954 with respect to the allowance of the deduction for depletion provides as follows:

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.

Under the terms of the trust in the instant case, the trustees are authorized to apportion and allocate between the trust and the beneficiaries thereof the appropriate tax deductions for depletion and depreciation and any other apportionable tax deductions, in such manner as the trustees see fit.

In the case of *William Fleming, Trustee* v. *Commissioner of Internal Revenue*, 121 Fed. (2d) 7, which involved the allowance of the deduction for depletion from income received from oil wells between the income beneficiaries and the trustee, the court held that where the trust instrument authorizes the trustee to distribute or withhold from the beneficiary all or part of corpus or income, and did not require allocation of any part of income or depletion to the beneficiary, it is mandatory that, in the absence of any apportionment provision in the instrument creating the trust, the deduction for depletion be apportioned between income beneficiaries and the trustee on the basis of trust income allocable to each.

Inasmuch as the trust instrument in the instant case authorized the trustee to allocate the depletion deduction between the trust and the beneficiaries in such manner as they may see fit, the allocation of all of the depletion deduction to the beneficiaries would be permissible under section 611(b)(3) of the Internal Revenue Code of 1954.

In view of the foregoing, it is held that where the manner in which the deduction for depletion may be apportioned and allocated between the income beneficiaries and the trust is, under the terms of the trust instrument, within the sole discretion of the trustees, they may properly allocate all of the depletion deduction to the beneficiaries and retain none for the trust although a substantial portion of the income from the depletable assets is retained by the trust.

(Also Part II, Section 23 (m); Regulations 118, Section 39.23(m)-10.) Rev. Rul. 56-252

The Internal Revenue Service will not further litigate the position taken in *United States* v. *J. L. Dougan et al.*, 214 Fed. (2d) 511, and *Commissioner* v. *Robert H. Miller*, 227 Fed. (2d) 326, that first year "rental" payments paid in the acquisition of noncompetitive government oil and gas leases are to be treated as nondepletable deductible expenditures. This concurrence does not extend to first year "rental" payments paid in the acquisition of oil and gas leases from private lessors.

Advice has been requested whether the decisions in *United States* v. *J. L. Dougan et al.*, 214 Fed. (2d) 511, and *Commissioner* v. *Robert H. Miller*, 227 Fed. (2d) 326, will affect the position of the Internal Revenue Service that first year "rental" payments by lessees of noncompetitive Government oil and gas leases obtained under the Mineral Lands Leasing Act of February 25, 1920, as amended, 60 Stat. 950, 30 U. S. C. 181, should be capitalized and recovered through depletion deductions under section 23(m) of the Internal Revenue Code of 1939 and section 611 of the Internal Revenue Code of 1954.

In the *Dougan* and *Miller* cases, the court held that the first year "rental" payments were ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the maintenance of property held for the production of income, under the provisions of section 23(a) of the Internal Revenue Code of 1939.

This issue will not be further litigated by the Government with respect to such noncompetitive *Government* oil and gas leases. The Internal Revenue Service has accordingly substituted an action of acquiescence, page 6 this Bulletin, for the outstanding action of nonacquiescence in *Olen F. Featherstone* v. *Commissioner*, 22 T. C. 763, C. B. 1954-2, 6.

Such substitute action, however, does not indicate that these decisions will be regarded by the Service as controlling in the case of first year "rental" payments made by lessees of private, nongovernmental oil and gas leases. Such payments will continue to be held to be capital investments in mineral property recoverable only through depletion.

SUBCHAPTER J.—ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

PART I.—ESTATES, TRUSTS, AND BENEFICIARIES

SUBPART A.—GENERAL RULES FOR TAXATION OF ESTATES AND TRUSTS

SECTION 642.—SPECIAL RULES FOR CREDITS AND DEDUCTIONS

Rev. Rul. 56-43

Expenses incurred in the sale of property, other than by a dealer, are considered as an offset against the sale price and not deductible as an ordinary and necessary business expense. See G. C. M. 15430,

C. B. XIV–2, 59 (1935). However, such expenses may not be used as an offset against the sale price of property in determining gain or loss for Federal income tax purposes where they have already been allowed as a deduction for Federal estate tax purposes. Such items of expense fall within the concept of section 642(g) of the Internal Revenue Code of 1954. Although section 642(g) of the Code refers to the disallowance of double deductions, it is the position of the Internal Revenue Service that such section contemplates the disallowance, as a *reduction* in computing the taxable income of the estate, of such items which have been allowed as a deduction in computing the taxable estate. See Rev. Rul. 240, C. B. 1953–2, 79.

SUBCHAPTER K.—PARTNERS AND PARTNERSHIPS

PART I.—DETERMINATION OF TAX LIABILITY

SECTION 701.—PARTNERS, NOT PARTNERSHIP, SUBJECT TO TAX

26 CFR 1.701: Statutory provisions: partners, not partnership, subject to tax. T. D. 6175 [1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER 1, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Regulations prescribed under subchapter K of chapter 1 of the Internal Revenue Code of 1954.

DEPARTMENT OF THE TREASURY,
OFFICE OF THE COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

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On August 12, 1955, notice of proposed rulemaking regarding the regulations under subchapter K of chapter 1 of the Internal Revenue Code of 1954 (Public Law 591, 83d Congress) approved August 16, 1954, was published in the Federal Register (20 F. R. 5854). After consideration of such relevant suggestions as were presented by interested persons regarding the proposals, the following regulations are hereby adopted:

PARTNERS AND PARTNERSHIPS

Determination of Tax Liability

§ 1.701 STATUTORY PROVISIONS; PARTNERS, NOT PARTNERSHIP, SUBJECT TO TAX.

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.

§ 1.701–1 PARTNERS, NOT PARTNERSHIP, SUBJECT TO TAX.—Partners are liable for income tax only in their separate capacities. Partnerships as such are not subject to the income tax imposed by subtitle A but are required to make returns of income under the provisions of section 6031 and the regulations thereunder. For definition of the terms "partner" and "partnership," see sections 761 and 7701(a)(2), and the regulations thereunder. For provisions relating to the election of certain partnerships to be taxed as domestic corporations, see section 1361 and the regulations thereunder.

§ 1.702 STATUTORY PROVISIONS; INCOME AND CREDITS OF PARTNER.

SEC. 702. INCOME AND CREDITS OF PARTNER.

(a) GENERAL RULE.—In determining his income tax, each partner shall take into account separately his distributive shart 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.

§ 1.702–1 INCOME AND CREDITS OF PARTNER.—(a) *General rule.*—Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction, or credit described in subparagraphs (1) through (9) of this paragraph. (For the taxable year in which a partner includes his distributive share of partnership taxable income, see section 706(a) and § 1.706–1(a). Such distributive share shall be determined as provided in section 704 and § 1.704–1.) Accordingly, in determining his income tax:

(1) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for not more than six months, his distributive share of the combined net amount of such gains and losses of the partnership.

(2) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for more than six months, his distributive share of the combined net amount of such gains and losses of the partnership.

(3) Each partner shall take into account, as part of his gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), his distributive share of the combined net amount of such gains and losses of the partnership. The partnership shall not combine such items with items set forth in subparagraph (1) or (2) of this paragraph.

(4) Each partner shall take into account, as part of the charitable contributions paid by him, his distributive share of each class of charitable contributions paid by the partnership within the partnership's taxable year. Section 170 determines the extent to which such amount may be allowed as a deduction to the partner. For the definition of the term "charitable contribution", see section 170(c).

(5) Each partner shall take into account, as part of the dividends received by him from domestic corporations, his distributive share of dividends received by the partnership, with respect to which the partner is entitled to a credit under section 34, an exclusion under section 116, or a deduction under part VIII of subchapter B.

(6) Each partner shall take into account, as part of his taxes described in section 901 which have been paid or accrued to foreign countries or to possessions of the United States, his distributive share of such taxes which have been paid or accrued by the partnership, according to its method of treating such taxes. A partner may elect to treat his total amount of such taxes, including his distributive share of such taxes of the partnership, as a deduction under section 164 or as a credit under section 901, subject to the provisions of sections 901 through 905.

(7) Each partner shall take into account, as part of the partially tax-exempt interest received by him on obligations of the United States or on obligations of instrumentalities of the United States, as described in section 35 or section 242, his distributive share of such partially tax-exempt interest received by the partnership. However, if the partnership elects to amortize premiums on bonds as provided in section 171, the amount received on such obligations by the partnership shall be reduced by the amor-

tizable bond premium applicable to such obligations as provided in section 171(a)(3).

(8)(i) Each partner shall take into account separately, as part of any class of income, gain, loss, deduction, or credit, his distributive share of the following items: recoveries of bad debts, prior taxes, and delinquency amounts (section 111); gains and losses from wagering transactions (section 165(d)); soil and water conservation expeditures (section 175); nonbusiness expenses as described in section 212; medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); amounts representing taxes and interest paid to cooperative housing corporations (section 216; intangible drilling and development costs (section 263(c)); exploration expeditures (section 615); income, gain, or loss to the partnership under section 751(b); and any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement which differs from the allocation of partnership taxable income or loss generally.

(ii) Each partner must also take into account separately his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately. Thus, if any partner would qualify for the retirement income credit under section 37 if the partnership pensions and annuities, interest, rents, dividends, and earned income were separately stated, such items must be separately stated for all partners. Under section 911(a), if any partner is a bona fide resident of a foreign country who may exclude from his gross income the part of his distributive share which qualifies as earned income as defined in section 911(b), the earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 270 (relating to "hobby losses") and the recomputation of tax thereunder for any partner.

(iii) Each partner shall aggregate the amount of his separate deductions or exclusions and his distributive share of partnership deductions or exclusions separately stated in determining the amount allowable to him of any deduction or exclusion under subtitle A as to which a limitation is imposed. For example, partner A has individual exploration expenditures of $75,000. He is also a member of the AB partnership which has exploration expenditures of $120,000. A's distributive share of this item is $60,000. However, the total amount that A can deduct as exploration expenditures under section 615(a) is limited to $100,000. Therefore, the excess of $35,000 ($135,000 minus $100,000) is not deductible by A.

(9) Each partner shall also take into account separately his distributive share of the taxable income or loss of the partnership, exclusive of items requiring separate computations under subparagraphs (1) through (8) of this paragraph. For limitation on allowance of a partner's distributive share of partnership losses, see section 704(d) and § 1.704–1(d).

(b) *Character of items constituting distributive share.*—The character in the hands of a partner of any item of income, gain, loss, deduction, or credit described in section 702(a)(1) through (8) 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. For example, a partner's distributive share of gain from the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner. Similarly, a partner's distributive share of partnership "hobby losses" (section 270) or his distributive share of partnership charitable contributions to churches, educational organizations, or hospitals (section 170(b)(1)(A)) retains such character in the hands of the partner.

(c) *Gross income of a partner.*—(1) Where it is necessary to determine the amount or character of the gross income of a partner, his gross income shall include the partner's distributive share of the gross income of the partnership, that is, the amount of gross income of the partnership from which was derived the partner's distributive share of partnership taxable income or loss (including items described in section 702(a)(1) through (8)). For example, a partner is required to include his distributive share of partnership gross income:

(i) In computing his gross income for the purpose of determining the necessity of filing a return (section 6012(a));

(ii) In determining the application of the provision permitting the spreading of income for services rendered over a 36-month period (section 1301);

(iii) In computing the amount of gross income received from sources within possessions of the United States (section 931); and

(iv) In determining a partner's "gross income from farming" (sections 175 and 6073).

(2) In determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a partner's gross income includes his distributive share of partnership gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of partnership gross income from which was derived the partner's distributive share of any item of partnership income, gain, loss, deduction, or credit (as included or disclosed in the partner's return) is considered as an amount of gross income stated in the partner's return for the purposes of section 6501(e). For example, A, who is entitled to one-fourth of the profits of the ABCD partnership, which has $10,000 gross income and $2,000 taxable income, reports only $300 as his distributive share of partnership profits. A should have shown $500 as his distributive share of profits, which amount was derived from $2,500 of partnership gross income. However, since A included only $300 on his return without explaining in the return the difference of $200, he is regarded as having stated in his return only $1,500 ($300/$500 of $2,500) as gross income from the partnership.

(d) *Partners in community property States.*—If separate returns are made by a husband and wife domiciled in a community property State, and only one spouse is a member of the partnership, the part of

his or her distributive share of any item or items listed in paragraph (a) (1) through (9) of this section which is community property, or which is derived from community property, should be reported by the husband and wife in equal proportions.

§ 1.702–2 NET OPERATING LOSS DEDUCTION OF PARTNER.—For the purpose of determining a net operating loss deduction under section 172, a partner shall take into account his distributive share of items of income, gain, loss, deduction, or credit of the partnership. The character of any such item 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. See section 702(b) and § 1.702–1(b). To the extent necessary to determine the allowance under section 172(d)(4) of the nonbusiness deductions of a partner (arising from both partnership and nonpartnership sources), the partner shall separately take into account his distributive share of the deductions of the partnership which are not attributable to a trade or business and combine such amount with his nonbusiness deductions from nonpartnership sources. Such partner shall also separately take into account his distributive share of the gross income of the partnership not derived from a trade or business and combine such amount with his non-business income from nonpartnership sources. See section 172 and the regulations thereunder.

§ 1.703 STATUTORY PROVISIONS; PARTNERSHIP COMPUTATIONS.

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.

§ 1.703–1 PARTNERSHIP COMPUTATIONS.—(a) *Income and deductions.*—(1) The taxable income of a partnership shall be computed in the same manner as the taxable income of an individual, except as otherwise provided in this section. A partnership is required to state separately in its return the items described in section 702(a)(1) through (7) and, in addition, to attach to its return a statement setting forth those items described in section 702(a)(8) which the partner is required to take into account separately in determining his

income tax. See § 1.702–1(a) (8). The partnership is further required to compute and to state separately in its return:

(i) As taxable income under section 702(a)(9), the total of all other items of gross income (not separately stated) over the total of all other allowable deductions (not separately stated), or

(ii) As loss under section 702(a)(9), the total of all other allowable deductions (not separately stated) over the total of all other items of gross income (not separately stated).

The taxable income or loss so computed shall be accounted for by the partners in accordance with their partnership agreement.

(2) The partnership is not allowed the following deductions:

(i) The standard deduction provided in section 141.

(ii) The deduction for personal exemptions provided in section 151.

(iii) The deduction provided in section 164(a) for taxes, described in section 901, paid or accrued to foreign countries or possessions of the United States. Each partner's distributive share of such taxes shall be accounted for separately by him as provided in section 702(a)(6).

(iv) The deduction for charitable contributions provided in section 170. Each partner is considered as having paid within his taxable year his distributive share of any contribution or gift, payment of which was actually made by the partnership within its taxable year ending within or with the partner's taxable year. This item shall be accounted for separately by the partners as provided in section 702(a)(4). See also § 1.702–1(b).

(v) The net operating loss deduction provided in section 172. See § 1.702–2.

(vi) The additional itemized deductions for individuals provided in part VII of subchapter B, as follows: expenses for production of income (section 212); medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); and amounts representing taxes and interest paid to cooperative housing corporation (section 216). However, see § 1.702–1(a)(8)(iv).

(vii) The deduction for capital gains provided by section 1202 and the deduction for capital loss carryover provided by section 1212.

(b) *Elections of the partnership.*—(1) *General rule.*—Any elections (other than the election with respect to foreign taxes) affecting the computation of income derived from a partnership shall be made by the partnership. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, of treating exploration expenditures, and the option to deduct as expenses intangible drilling and development costs, shall be made by the partnership and not by the partners separately. All partnership elections are applicable to all partners equally, but any election made by a partnership shall not apply to any partner's nonpartnership interests.

(2) *Exception.*—Each partner shall add his distributive share of taxes described in section 901 paid or accrued by the partnership to foreign countries or possessions of the United States (according to its

method of treating such taxes) to any such taxes paid or accrued by him (according to his method of treating such taxes), and may elect to use the total amount either as a credit against tax or as a deduction from income.

§ 1.704 STATUTORY PROVISIONS; PARTNER'S DISTRIBUTIVE SHARE.

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.

§ 1.704–1 PARTNER'S DISTRIBUTIVE SHARE.—(a) *Effect of partnership agreement.*—A partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704 and paragraphs (b) through (e) of this section. For definition of partnership agreement, see section 761(c).

(b) *Distributive share determined by income or loss ratio.*—(1) If the partnership agreement makes no specific provision for the manner of sharing one or more items or classes of items, a partner's distributive share of such items shall be determined in accordance with the provisions of the partnership agreement for the division of the general profits or losses (that is, the taxable income or loss of the partnership as described in section 702(a)(9)). In applying this rule, the manner in which the net profit or loss (computed after excluding any item subject to a recognized special allocation) is actually credited on the partnership books to the accounts of the partners will generally determine each partner's share of taxable income or loss as described in section 702(a)(9).

(2) If the principal purpose of any provision in the partnership agreement determining a partner's distributive share of a particular item is to avoid or evade the Federal income tax, the provision shall be disregarded and the partners' distributive shares of that item shall be determined in accordance with the ratio in which the partners divide the general profits or losses of the partnership (as described in section 702(a)(9)). In determining whether the principal purpose of any provision in the partnership agreement for a special allocation is the avoidance or evasion of Federal income tax, the provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect", that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation. The application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). The provisions of a partnership agreement for a year in which the partnership incurs losses on the sale of depreciable property used in the trade or business are amended to

allocate such losses to one partner who has no such gains individually. An equivalent amount of partnership loss or deduction of a different character is allocated to other partners who individually have gains from the sale of depreciable property used in the trade or business. Since the purpose and effect of this allocation is solely to reduce the taxes of certain partners without actually affecting their shares of partnership income, such allocation will not be recognized. Under section 704(b)(2), those items will be allocated to all the partners in accordance with the provisions of the partnership agreement for sharing partnership income or loss generally.

Example (2). The provisions of a partnership agreement allocate to a partner who is a resident of a foreign country a percentage of the profit derived from operations conducted by him within such country, which percentage is greater than his distributive share of partnership income generally. Such allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose was tax avoidance or evasion.

Example (3). Rather than impair the credit standing of the AB partnership by a distribution, the partners agree to invest surplus partnership funds in an equal dollar amount of municipal bonds and corporate stock. The partners further agree that A is to receive all the interest income and gain or loss from tax-exempt bonds and B is to receive all the dividend income and gain or loss from corporate stock. Such allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose was tax avoidance or evasion. On the other hand, under an agreement with respect to partnership CD, it is provided that C's distributive share of income shall be the first $10,000 of tax-exempt income, and D's distributive share of income shall be the first $10,000 of dividend income, the balances to be divided equally. Since the principal purpose of this provision is to allocate tax-exempt interest to C, who is in a higher income tax bracket than D, it will be disregarded. Each partner's distributive share of such interest and dividends will then be allocated in accordance with the provisions of the partnership agreement for sharing partnership income or loss generally.

Example (4). KL is a brokerage partnership with assets consisting of securities with a basis of $20,000 and a value of $50,000. M makes a $25,000 cash contribution to the partnership in order to become an equal partner. Subsequently, when the value of the securities has appreciated to $74,000, they are sold. Of the $54,000 taxable gain on the sale of the securities, $24,000 (appreciation in value occurring after M became a partner) is allocated in equal shares to K, L, and M, in accordance with the ratio for sharing profits and losses generally. The $30,000 balance is allocated to K and L in the profit and loss ratio existing before M became a partner. This latter allocation attributes to K and L the appreciation in value of the securities occuring before M became a partner, even though the cash proceeds are a partnership asset in which all three partners share equally. This allocation has substantial economic effect and will be recognized in the absence of other circum-

stances showing that the principal purpose of the allocation was tax avoidance or evasion.

Example (5). G and H enter into a partnership agreement to develop and market an electronic device. H, an electronics engineer, contributes $2,500 cash and agrees to devote his full-time services to the partnership. G contributes $100,000 cash and agrees to obtain a loan for the partnership of any additional capital needed. The partnership agreement provides that the full amount of any research and experimental expenditures and any interest on partnership loans are to be charged to G. It also provides that G's distributive share is to be 90 percent of partnership income or loss computed without reduction by such research and experimental expenditures and such interest, until all loans have been repaid and G has received through his 90-percent share of income an amount equal to the full amount of such research and experimental expenditures, of such interest, and his share of any partnership operating losses. During this time H's distributive share will be 10 percent. Thereafter, G and H will share profits and losses equally. Since all of the research and experimental expenditures and interest specially allocated to G are in fact borne by G, the allocation will be recognized in the absence of other circumstances showing that its principal purpose was tax avoidance or evasion.

(c) *Contributed property.*—(1) *In general.*—Where property has actually been contributed by a partner to a partnership (so as to become partnership property as among the partners and not merely property subject to the claims of partnership creditors), section 704(c) and this paragraph provide rules for determining a partner's distributive share of depreciation, depletion, or gain or loss with respect to such contributed property. These rules do not apply to property, only the use of which is permitted the partnership by the partner who owns it. Section 704 (c) and this paragraph provide certain alternatives in determining the partners' distributive shares of such items in order to account for precontribution appreciation or diminution in value of the property contributed. When the partnership agreement is silent as to the treatment of such items with respect to contributed property (and if such property is not an undivided interest as described in section 704(c)(3)), depreciation, depletion, or gain or loss with respect to such property shall be treated in the same manner as though such items arose with respect to property purchased by the partnership. The application of this provision may be illustrated by the following examples:

Example (1). A and B form an equal partnership. A contributes $1,000 cash and B contributes inventory with an adjusted basis to him of $800 and a fair market value of $1,000. Under section 723, the basis of the inventory to the partnership is also $800. During the year, the inventory is sold for $1,100. There is no provision in the partnership agreement for treatment of items with respect to contributed property. Under section 704(c)(1), the $300 profit on the sale of the inventory is treated as if it were gain on property that had been purchased by the partnership and subsequently sold. Therefore, each partner's distributive share of such profit on the inventory is $150.

Example (2). C and D form an equal partnership. C contributes machinery worth $10,000 with an adjusted basis to him of $4,000. D contributes $10,000 cash. Under the provisions of section 722, the basis of A's partnership interest is $4,000 and the basis of B's interest is $10,000. There is no provision in the partnership agreement relating to contributed property. If the contributed property depreciates at an annual rate of 10 percent, the partnership will have an annual depreciation deduction of $400, which will result in a reduction of $200 in each partner's distributive share of partnership income. Thus, at the end of the first year, the adjusted basis of the contributed property will be $3,600. If the partnership has no other taxable income or loss for that year, each partner will have a deduction of $200, representing his distributive share of partnership loss for the year. C's adjusted basis for his interest will be $3,800 ($4,000, the original basis of his interest, reduced by $200); D's adjusted basis will be $9,800 ($10,000, reduced by $200).

Example (3). Assume that the property in example (2) of this subparagraph is sold at the beginning of the second year of partnership operation for $9,000. The partnership gain will be $5,400 ($9,000, the amount realized, less the adjusted basis of $3,600). Each partner's share of the $5,400 gain will be $2,700. If the partnership has no other taxable income or loss for that year, each partner will have a gain from the partnership of $2,700, representing his distributive share of gain from the sale of property used in the partnership business. C's adjusted basis for his interest will then be $6,500 (the basis of $3,800, increased by the gain of $2,700). D's adjusted basis will be $12,500 (the basis of $9,800, increased by the gain of $2,700). If the partnership is then terminated, and its assets consisting of $19,000 in cash are distributed to the partners pro rata in liquidation of their entire interests, C will have a capital gain of $3,000 ($9,500, the amount received, less $6,500, the adjusted basis of his interest). D will have a capital loss of $3,000 (D's adjusted basis, $12,500, reduced by the amount received, $9,500).

(2) *Effect of partnership agreement.*—(i) If the partners so provide in the partnership agrement, depreciation, depletion, or gain or loss with respect to contributed property may be allocated among the partners in a manner which takes into account all or any portion of the difference between the adjusted basis and the fair market value of contributed property at the time of contribution. The allocation may apply to all contributed property or to specific items. The appreciation or diminution in value represented by the difference between the adjusted basis and the fair market value of contributed property at the time of contribution may thus be attributed to the contributing partner upon a subsequent sale or exchange of the property by the partnership. Such appreciation or diminution also may be used in allocating the allowable depreciation or depletion with respect to such property among the contributing partner and the noncontributing partners. In any case, however, the total depreciation, depletion, or gain or loss allocated to the partners is limited to a "ceiling" which cannot exceed the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to it. The application of this subdivision may be illustrated by the following examples:

Example (1). Assume that partners C and D, in examples (2) and (3) of subparagraph (1) of this paragraph, agree under section 704(c)(2) to attribute to C, the contributor of the machinery, the potential gain of $6,000 represented by the difference between its adjusted basis of $4,000 and its fair market value of $10,000. With his contribution of $10,000 cash, D has, in effect, purchased an undivided one-half interest in the property for $5,000. Since the property depreciates at an annual rate of 10 percent, D would have been entitled to a depreciation deduction of $500 per year. However, since under the "ceiling" approach the partnership is allowed only $400 per year (10 percent of $4,000), no more than $400 may be allocated between the partners, i. e., the partnership cannot allocate $500 of depreciation to D and thereby treat C as if C had received an additional $100 of income. Therefore, the partners allocated the $400 deduction for depreciation entirely to D and none to C, the contributor. At the end of the first year, the adjusted basis of the contributed property will be $3,600. Since the $400 deduction is allocated entirely to D, if the partnership has no other taxable income or loss, C will have no income or loss, and D will have a deduction of $400. C's basis for his interest will remain $4,000. D's adjusted basis for his interest will be $9,600 ($10,000, the original basis of his interest, reduced by the deduction of $400).

Example (2). Assume that the partners in example (1) of this subdivision also agree under section 704(c)(2) that, upon a sale of the contributed property, the portion of the proceeds attributable to the excess of the fair market value of the property at date of contribution (less accumulated depreciation on such value) over its basis at date of contribution (less accumulated depreciation on such basis) shall result in gain to the contributing partner only. If the property is sold at the beginning of the second year of partnership operation for $9,000, the partnership gain of $5,400 ($9,000, the amount realized, less the adjusted basis of $3,600) must be allocated to the partners under the terms of the agreement. The fair market value of the property as depreciated is $9,000 ($10,000, the value on contribution, less $1,000, the accumulated depreciation on such value). Under section 704(c)(2) and the terms of the partnership agreement, the $5,400 difference between $9,000, the fair market value as depreciated, and $3,600, the adjusted basis of the property, represents the portion of the gain to be allocated to C. None of this gain is allocated to D. (If the property were sold for more than $9,000, the portion of the gain in excess of $5,400 would be allocated equally between the partners in accordance with their agreement for sharing gains. If the property were sold for less than $9,000, the entire gain would be allocated to C and nothing to D.) If the partnership and partners engaged in no other transactions that year, C will report a gain of $5,400, and D, no income or loss. C's adjusted basis for his interest will then be $9,400 ($4,000, his original basis, increased by the gain of $5,400). D's adjusted basis will be $9,600 ($10,000, his original basis, less $400 depreciation deduction in the first partnership year). If the partnership is then terminated, and its assets consisting of $19,000 in cash are

distributed to the partners pro rata in liquidation of their interest, C will have a capital gain of $100 ($9,500, the amount received, less $9,400, the adjusted basis of his interest). D will have a capital loss of $100 (the excess of D's adjusted basis, $9,600, over the amount received, $9,500).

(ii) For the effect of an agreement under section 704(c)(2) on undivided interests in property contributed to the partnership where the partners' interests in the capital and profits of the partnership do not correspond with such undivided interests, see subparagraph (3)(ii) of this paragraph.

(3) *Undivided interests.*—(i) Section 704(c)(3) provides a special rule for the allocation of depreciation, depletion, or gain or loss with respect to undivided interests in property contributed by the partners to a partnership where the partnership agreement does not provide otherwise. This provision applies only to property contributed to a partnership by all of its partners and only where the relative undivided interests of the partners in the property prior to the contribution are in the same ratio as their interests in the capital and in the profits of the partnership (except for depreciation, depletion, or gain or loss with respect to the contributed undivided interest) after the contribution. Where these conditions are met, depreciation, depletion, or gain or loss with respect to the undivided interests in contributed property shall be determined in the same manner as though such undivided interests continued to be held by the partners outside the partnership. The rule stated in section 704(c)(3) applies only to the case where persons actually contribute undivided interests to a partnership. The provisions of this subdivision may be illustrated by the following examples:

Example (1). A and B are tenants in common owning undivided one-half interests in improved real estate consisting of land on which a factory is situated. They each contribute their respective undivided interests in the real estate to a partnership in which the profits are to be divided equally and, because the partners have equal shares in the capital, the assets will be divided equally on dissolution. A's basis for his undivided one-half interest is $4,000, of which $1,000 is allocable to the land and $3,000 to the factory. B's basis for his undivided one-half interest is $10,000, of which $3,000 is allocable to the land and $7,000 to the factory. The partnership agreement contains no provisions as to the allocation of depreciation or gain or loss on disposition of the property by the partnership. The factory depreciates at a rate of 5 percent a year. The annual partnership allowance for depreciation of $500 (5 percent of $10,000) will be allocated between the partners by allowing A a deduction of $150 (5 percent of $3,000, his basis for his undivided interest in the factory), and by allowing B a deduction of $350 (5 percent of $7,000, his basis for his undivided interest in the factory). At the end of the first year of partnership operation, A's adjusted basis for his undivided interest in the factory is $2,850 ($3,000 less $150), and B's adjusted basis is $6,650 ($7,000 less $350).

Example (2). If, in example (1) of this subdivision, the partnership at the end of the first year's operation sells the factory and land for $12,000, each partner's share of the gain or loss would be

determined as follows: Since the undivided interests in the factory and the land are to be treated as though held by the partners outside the partnership, A's share of the proceeds of the sale is $6,000. His adjusted basis in the contributed property is $3,850 ($1,000 for the land and $2,850 for the factory). Therefore, his gain from the sale is $2,150. Since B's share of the proceeds is also $6,000, and his adjusted basis in the contributed property is $9,650 ($3,000 for the land and $6,650 for the factory), his loss is $3,650.

Example (3). Assume the same facts as in examples (1) and (2) of this subdivision, except that A and B do not enter into a partnership agreement. Assume further that they are found to be a partnership for income tax purposes because of their joint business activity, but that the factory and the land are not actually contributed by them to the partnership. Although A and B have permitted the partnership to use such properties, they continue to own the factory and the land in their individual capacities (as tenants in common), and the same tax consequences result as in examples (1) and (2) of this subdivision.

(ii) The allocation illustrated in subdivision (i) of this subparagraph will not be effected by the contribution, either at the time of the original contribution or subsequent thereto, of additional property not held as undivided interests if the partners' respective interests in the capital and in the profits of the partnership (except for depreciation, depletion, or gain or loss with respect to the contributed undivided interests) remain the same as their undivided interests in the property previously contributed to the partnership. If the partners' interests in the capital and profits of the partnership are changed from their undivided interests in the property previously contributed to the partnership, the method of allocation of depreciation, depletion, or gain or loss with respect to such property no longer applies. Such a change of the partner's itnerests in capital and profits may result from a modification of the agreement, or from a change in a partner's respective interest in capital either as a result of a further contribution or as a result of a distribution. (However, drawings made throughout the year against profits, and loans will be disregarded.) Where such a change takes place, the partners may agree under section 704(c)(2) that depreciation, depletion, or gain or loss with respect to the property formerly held as undivided interests shall continue to be allocated in the same manner as prior to the change. These provisions may be illustrated by the following examples:

Example (1). C and D are tenants in common, each owning an undivided one-half interest in certain unimproved land. Each contributes his respective undivided interest in the land to a partnership in which each has an equal itnerest in capital and profits. C's basis for his one-half interest is $4,000; D's basis is $10,000. The fair market value of the land is $20,000. Subsequently, C contributes $5,000 cash to his share of partnership capital. As a result of C's additional contribution, he now has a 60-percent interest in partnership capital and D, a 40-percent interest, although profits and losses still are to be shared equally. Since the interests of the partners in the capital and profits of the partnership no longer correspond to their undivided interests in the land, the method of allocation prescribed by section 704(c)(3) no longer

applies. Therefore, if the land is sold for $12,000, the partnership will have a loss of $2,000 ($14,000 partnership basis minus $12,000). Since the partnership agreement contains no special allocation for gain or loss with respect to contributed property, the $2,000 loss is allocated as if such property had been purchased by the partnership, i. e., $1,000 to each partner.

Example (2). Assume in example (1) of this subdivision that the partners agree that, because of C's additional contribution of $5,000 cash, he is to have a 60-percent interest in partnership capital. Profits and losses still are to be shared equally, except that gain or loss with respect to the land is, under section 704(c)(2), to continue to be allocated in the same manner as it had been allocated under section 704(c)(3) prior to the additional contribution. The land is sold for $12,000. C's share of the proceeds is $6,000. His basis for the land is $4,000. Therefore, he has a $2,000 gain. D's loss is $4,000 ($10,000 basis less $6,000 proceeds).

(d) *Limitation on allowance of losses.* (1) a partner's distributive share of partnership loss will be allowed only to the extent of the adjusted basis (before reduction by current year's losses) of such partner's interest in the partnership at the end of the partnership taxable year in which such loss occurred. A partner's share of loss in excess of his adjusted basis at the end of the partnership taxable year will not be allowed for that year. However, any loss so disallowed shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).

(2) In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705(a)(1) and decreased under section 705(a)(2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a) (1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the sum of his distributive share of losses for the current year and his losses disallowed and carried forward from prior years.

(3) For the treatment of certain liabilities of the partner or partnership, see section 752 and § 1.752–1.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example (1). At the end of the partnership taxable year 1955, partnership AB has a loss of $20,000. Partner A's distributive share of this loss is $10,000. At the end of such year, A's adjusted basis for his interest in the partnership (not taking into account his distributive share of the loss) is $6,000. Under section 704 (d), A's distributive share of partnership loss is allowed to him

(in his taxable year within or with which the partnership taxable year ends) only to the extent of his adjusted basis of $6,000. The $6,000 loss allowed for 1955 decreases the adjusted basis of A's interest to zero. Assume that, at the end of partnership taxable year 1956, A's share of partnership income has increased the adjusted basis of A's interest in the partnership to $3,000 (not taking into account the $4,000 loss disallowed in 1955). Of the $4,000 loss disallowed for the partnership taxable year 1955, $3,000 is allowed A for the partnership taxable year 1956, thus again decreasing the adjusted basis of his interest to zero. If, at the end of partnership taxable year 1957, A has an adjusted basis of his interest of at least $1,000 (not taking into account the disallowed loss of $1,000), he will be allowed the $1,000 loss previously disallowed.

Example (2). At the end of partnership taxable year 1955, partnership CD has a loss of $20,000. Partner C's distributive share of this loss is $10,000. The adjusted basis of his interest in the partnership (not taking into account his distributive share of such loss) is $6,000. Therefore, $4,000 of the loss is disallowed. At the end of partnership taxable year 1956, the partnership has no taxable income or loss, but owes $8,000 to a bank for money borrowed. Since C's share of this liability is $4,000, the basis of his partnership interest is increased from zero to $4,000. (See sections 752 and 722, and §§ 1.752–1 and 1.722–1.) C is allowed the $4,000 loss, disallowed for the preceding year under section 704(d), for his taxable year within or with which partnership taxable year 1956 ends.

Example (3). At the end of partnership taxable year 1955, partner C has the following distributive share of partnership items described in section 702(a): long-term capital loss, $4,000; short-term capital loss, $2,000; income as described in section 702(a)(9), $4,000. Partner C's adjusted basis for his partnership interest at the end of 1955, before adjustment for any of the above items, is $1,000. As adjusted under section 705(a)(1)(A), C's basis is increased from $1,000 to $5,000 at the end of the year. C's total distributive share of partnership loss is $6,000. Since without regard to losses, C has a basis of only $5,000, C is allowed only $5,000/$6,000 of each loss, that is, $3,333 of his long-term capital loss, and $1,667 of his short-term capital loss. C must carry forward to succeeding taxable years $667 as a long-term capital loss and $333 as a short-term capital loss.

(e) *Family partnerships.*—(1) *In general.*—(i) *Introduction.*—The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of subchapter K are to be read in the light of their relationship to section 61, which requires, inter alia, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

(ii) *Recognition of donee as partner.*—With respect to partnerships in which capital is a material income-producing factor, section 704(e)(1) provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in such a partnership, whether or not such interest is derived by purchase or gift from any other person. If a capital interest in a partnership in which capital is a mate-

rial income-producing factor is created by gift, section 704(e)(2) provides that the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such distributive 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 distributive share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. For rules of allocation in such cases, see subparagraph (3) of this paragraph.

(iii) *Requirement of complete transfer to donee.*—A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes, and the donee or purchaser is the real owner of such interest. To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee. The existence of such dominion and control in the donee is to be determined from all the facts and circumstances. A transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest. Transactions between members of a family will be closely scrutinized, and the circumstances, not only at the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides or lack of bona fides of the purported gift or sale. A partnership may be recognized for income tax purposes as to some partners but not as to others.

(iv) *Capital as a material income-producing factor.*—For purposes of section 704(e)(1), the determination as to whether capital is a material income-producing factor must be made by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business reequires substantial inventories or a substantial investment in plant, machinery, or other equipment.

(v) *Capital interest in a partnership.*—For purposes of section 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

(2) *Basic tests as to ownership.*—(i) *In general.*—Whether an alleged partner who is a donee of a capital interest in a partnership is the real owner of such capital interest, and whether the donee has dominion and control over such interest, must be ascertained from all the facts and circumstances of the particular case. Isolated facts are not determinative: the reality of the donee's ownership is to be determined in the light of the transaction as a whole. The execution of

legally sufficient and irrevocable deeds or other instruments of gift under State law is a factor to be taken into account but is not determinative of ownership by the donee for the purposes of section 704(e). The reality of the transfer and of the donee's ownership of the property attributed to him are to be ascertained from the conduct of the parties with respect to the alleged gift and not by any mechanical or formal test. Some of the more important factors to be considered in determining whether the donee has acquired ownership of the capital interest in a partnership are indicated in subdivisions (ii) to (x), inclusive, of this subparagraph.

(ii) *Retained controls.*—The donor may have retained such controls of the interest which he has purported to transfer to the donee that the donor should be treated as remaining the substantial owner of the interest. Controls of particular significance include, for example, the following:

(*a*) Retention of control of the distribution of amounts of income or restrictions on the distributions of amounts of income (other than amounts retained in the partnership annually with the consent of the partners, including the donee partner, for the reasonable needs of the business). If there is a partnership agreement providing for a managing partner or partners, then amounts of income may be retained in the partnership without the acquiescence of all the partners if such amounts are retained for the reasonable needs of the business.

(*b*) Limitation of the right of the donee to liquidate or sell his interest in the partnership at his discretion without financial detriment.

(*c*) Retention of control of assets essential to the business (for example, through retention of assets leased to the alleged partnership).

(*d*) Retention of management powers inconsistent with normal relationships among partners. Retention by the donor of control of business management or of voting control, such as is common in ordinary business relationships, is not by itself to be considered as inconsistent with normal relationships among partners, provided the donee is free to liquidate his interest at his discretion without financial detriment. The donee shall not be considered free to liquidate his interest unless, considering all the facts, it is evident that the donee is independent of the donor and has such maturity and understanding of his rights as to be capable of deciding to exercise, and capable of exercising, his right to withdraw his capital interest from the partnership.

The existence of some of the indicated controls, though amounting to less than substantial ownership retained by the donor, may be considered along with other facts and circumstances as tending to show the lack of reality of the partnership interest of the donee.

(iii) *Indirect controls.*—Controls inconsistent with ownership by the donee may be exercised indirectly as well as directly, for example, through a separate business organization, estate, trust, individual, or other partnership. Where such indirect controls exist, the reality of the donee's interest will be determined as if such controls were exercisable directly.

(iv) *Participation in management.*—Substantial participation by the donee in the control and management of the business (including participation in the major policy decisions affecting the business) is strong evidence of a donee partner's exercise of dominion and control over his interest. Such participation presupposes sufficient maturity and experience on the part of the donee to deal with the business problems of the partnership.

(v) *Income distributions.*—The actual distribution to a donee partner of the entire amount or a major portion of his distributive share of the business income for the sole benefit and use of the donee is substantial evidence of the reality of the donee's interest, provided the donor has not retained controls inconsistent with real ownership by the donee. Amounts distributed are not considered to be used for the donee's sole benefit if, for example, they are deposited, loaned, or invested in such manner that the donor controls or can control the use or enjoyment of such funds.

(vi) *Conduct of partnership business.*—In determining the reality of the donees ownership of a capital interest in a partnership, consideration shall be given to whether the donee is actually treated as a partner in the operation of the business. Whether or not the donee has been held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources of financing, is of primary significance. Other factors of significance in this connection include:

(*a*) Compliance with local partnership, fictitious names, and business registration statutes.

(*b*) Control of business bank accounts.

(*c*) Recognition of the donee's rights in distributions of partnership property and profits.

(*d*) Recognition of the donee's interest in insurance policies, leases, and other business contracts and in litigation affecting business.

(*e*) The existence of written agreements, records, or memoranda, contemporaneous with the taxable year or years concerned, establishing the nature of the partnership agreement and the rights and liabilities of the respective partners.

(*f*) Filing of partnership tax returns as required by law.

However, despite formal compliance with the above factors, other circumstances may indicate that the donor has retained substantial ownership of the interest purportedly transferred to the donee.

(vii) *Trustees as partners.*—A trustee may be recognized as a partner for income tax purposes under the principles relating to family partnerships generally as applied to the particular facts of the trust-partnership arrangement. A trustee who is unrelated to and independent of the grantor, and who participates as a partner and receives distribution of the income distributable to the trust, will ordinarily be recognized as the legal owner of the partnership interest which he holds in trust unless the grantor has retained controls inconsistent with such ownership. However, if the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly as to whether the trustee is subject to the responsibilities of a fiduciary), the provisions of the

partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest. Where the grantor (or person amenable to his will) is the trustee, the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor. Furthermore, if the grantor (or person amenable to his will) is the trustee, the following factors will be given particular consideration:

(*a*) Whether the trust is recognized as a partner in business dealings with customers and creditors, and

(*b*) Whether, if any amount of the partnership income is not properly retained for the reasonable needs of the business, the trust's share of such amount is distributed to the trust annually and paid to the beneficiaries or reinvested with regard solely to the interests of the beneficiaries.

(viii) *Interests (not held in trust) of minor children.*—Except where a minor child is shown to be competent to manage his own property and participate in the partnership activities in accordance with his interest in the property, a minor child generally will not be recognized as a member of a partnership unless control of the property is exercised by another person as fiduciary for the sole benefit of the child, and unless there is such judicial supervision of the conduct of the fiduciary as is required by law. The use of the child's property or income for support for which a parent is legally responsible will be considered a use for the parent's benefit. "Judicial supervision of the conduct of the fiduciary" includes filing of such accountings and reports as are required by law of the fiduciary who participates in the affairs of the partnership on behalf of the minor. A minor child will be considered as competent to manage his own property if he actually has sufficient maturity and experience to be treated by distinterested persons as competent to enter business dealings and otherwise to conduct his affairs on a basis of equality with adult persons, notwithstanding legal disabilities of the minor under State law.

(ix) *Donees as limited partners.*—The recognition of a donee's interest in a limited partnership will depend, as in the case of other donated interests, on whether the transfer of property is real and on whether the donee has acquired dominion and control over the interest purportedly transferred to him. To be recognized for Federal income tax purposes, a limited partnership must be organized and conducted in accordance with the requirements of the applicable State limited-partnership law. The absence of services and participation in management by a donee in a limited partnership is immaterial if the limited partnership meets all the other requirements prescribed in this paragraph. If the limited partner's right to transfer or liquidate his interest is subject to substantial restrictions (for example, where the interest of the limited partner is not assignable in a real sense or where such interest may be required to be left in the business for a long term of years), or if the general partner retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relation-

ships, such restrictions on the right to transfer or liquidate, or retention of other control, will be considered strong evidence as to the lack of reality of ownership by the donee.

(x) *Motive.*—If the reality of the transfer of interest is satisfactorily established, the motives for the transaction are generally immaterial. However, the presence or absence of a tax-avoidance motive is one of many factors to be considered in determining the reality of the ownership of a capital interest acquired by gift.

(3) *Allocation of family partnership income.*—(i) *In general.*—(*a*) Where a capital interest in a partnership in which capital is a material income-producing factor is created by gift, the donee's distributive share 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 distributive share attributable to donated capital is proportionately greater than the distributive share attributable to the donor's capital. For the purpose of section 704, a capital interest in a partnership 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, for the purpose of the preceding sentence, shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

(*b*) To the extent that the partnership agreement does not allocate the partnership income in accordance with subdivision (*a*) of this subdivision, the distributive shares of the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between the donor and donee in accordance with their respective interests in partnership capital.

(*c*) In determining a reasonable allowance for services rendered by the partners, consideration shall be given to all the facts and circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. There shall also be considered the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the partnership.

(*d*) The distributive share of partnership income, as determined under subdivision (*b*) of this subdivision, of a partner who rendered services to the partnership before entering the Armed Forces of the United States shall not be diminished because of absence due to military service. Such distributive share shall be adjusted to reflect increases or decreases in the capital interest of the absent partner. However, the partners may by agreement allocate a smaller share to the absent partner due to his absence.

(ii) *Special rules.*—(*a*) The provisions of subdivision (i) of this subparagraph, relating to allocation of family partnership income, are applicable where the interest in the partnership is created by gift,

indirectly or directly. Where the partnership interest is created indirectly, the term "donor" may include persons other than the nominal transferor. This rule may be illustrated by the following examples:

Example (1). A father gives property to his son who shortly thereafter conveys the property to a partnership consisting of the father and the son. The partnership interest of the son may be considered created by gift and the father may be considered the donor of the son's partnership interest.

Example (2). A father, the owner of a business conducted as a sole proprietorship, transfers the business to a partnership consisting of his wife and himself. The wife subsequently conveys her interest to their son. In such case, the father, as well as the mother, may be considered the donor of the son's partnership interest.

Example (3). A father makes a gift to his son of stock in the family corporation. The corporation is subsequently liquidated. The son later contributes the property received in the liquidation of the corporation to a partnership consisting of his father and himself. In such case, for purposes of section 704, the son's partnership interest may be considered created by gift and the father may be considered the donor of his son's partnership interest.

(*b*) The allocation rules set forth in section 704 (e) and subdivision (i) of this subparagraph apply in any case in which the transfer or creation of the partnership interest has any of the substantial characteristics of a gift. Thus, allocation may be required where transfer of a partnership interest is made between members of a family (including collaterals) under a purported purchase agreement, if the characteristics of a gift are ascertained from the terms of the purchase agreement, the terms of any loan or credit arrangements made to finance the purchase, or from other relevant data.

(*c*) In the case of a limited partnership, for the purpose of the allocation provisions of subdivision (i) of this subparagraph, consideration shall be given to the fact that a general partner, unlike a limited partner, risks his credit in the partnership business.

(4) *Purchased interest.*—(i) *In general.*—If a purported purchase of a capital interest in a partnership does not meet the requirements of subdivision (ii) of this subparagraph, the ownership by the transferee of such capital interest will be recognized only if it qualifies under the requirements applicable to a transfer of a partnership interest by gifts. In a case not qualifying under subdivision (ii) of this subparagraph, if payment of any part of the purchase price is made out of partnership earnings, the transaction may be regarded in the same light as a purported gift subject to deferred enjoyment of income. Such a transaction may be lacking in reality either as a gift or as a bona fide purchase.

(ii) *Tests as to reality of purchased interest.*—A purchase of a capital interest in a partnership, either directly or by means of a loan or credit extended by a member of the family, will be recognized as bona fide if:

(*a*) It can be shown that the purchase has the usual characteristics of an arm's-length transaction, considering all relevant

factors, including the terms of the purchase agreement (as to price, due date of payment, rate of interest, and security, if any) and the terms of any loan or credit arrangement collateral to the purchase agreement; the credit standing of the purchaser (apart from relationship to the seller) and the capacity of the purchaser to incur a legally binding obligation; or

(*b*) It can be shown, in the absence of characteristics of an arm's-length transaction, that the purchase was genuinely intended to promote the success of the business by securing participation of the purchaser in the business or by adding his credit to that of the other participants.

However, if the alleged purchase price or loan has not been paid or the obligation otherwise discharged, the factors indicated in subdivisions (*a*) and (*b*) of this subdivision shall be taken into account only as an aid in determining whether a bona fide purchase or loan obligation existed.

§ 1.705 STATUTORY PROVISIONS; DETERMINATION OF BASIS OF PARTNER'S INTEREST.

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.

§ 1.705–1 DETERMINATION OF BASIS OF PARTNER'S INTEREST—(a) *General rule.*—(1) Section 705 and this section provide rules for determining the adjusted basis of a partner's interest in a partnership. A partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership taxable year. Thus, for example, such year-end determination is necessary in ascertaining the extent to which a partner's distributive share of partnership losses may be allowed. See section 704(d). However, where there has been a sale or exchange of all or a part of a partnership interest or a liquidation of a partner's entire interest in a partnership, the adjusted basis of the partner's

interest should be determined as of the date of sale or exchange or liquidation. The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's "capital", "equity", or similar account. For example, A contributes property with an adjusted basis to him of $400 (and a value of $1,000) to a partnership. B contributes $1,000 cash. While under their agreement each may have a "capital account" in the partnership of $1,000, the adjusted basis of A's interest is only $400 and B's interest, $1,000.

(2) The original basis of a partner's interest in a partnership shall be determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests). Such basis shall be increased under section 722 by any further contributions to the partnership and by the sum of the partner's distributive share for the taxable year and prior taxable years of—

(i) Taxable income of the partnership as determined under section 703(a),

(ii) Tax-exempt receipts of the partnership, and

(iii) The excess of the deductions for depletion over the basis of the depletable property.

(3) The basis shall be decreased (but not below zero) by distributions from the partnership as provided in section 733 and by the sum of the partner's distributive share for the taxable year and prior taxable years of—

(i) Partnership losses (including capital losses), and

(ii) Partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures.

(4) For the effect of liabilities in determining the amount of contributions made by a partner to a partnership or the amount of distributions made by a partnership to a partner, see section 752 and § 1.752–1, relating to the treatment of certain liabilities. In determining the basis of a partnership interest on the effective date of subchapter K or any of the sections thereof, the partner's share of partnership liabilities on that date shall be included.

(b) *Alternative rule.*—In certain cases, the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of partnership property which would be distributable upon termination of the partnership. The alternative rule may be used to determine the adjusted basis of a partner's interest where circumstances are such that the partner cannot practicably apply the general rule set forth in section 705(a) and paragraph (a) of this section, or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternate rule is used, adjustments may be necessary in determining the adjusted basis of a partner's interest in a partnership. Adjustments would be required, for example, in order to reflect in a partner's share of the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners. The operation of the alternative rules may be illustrated by the following examples:

Example (1). The ABC partnership, in which A, B, and C are equal partners, owns various properties with a total adjusted basis of $1,500 and has earned and retained an additional $1,500. The total adjusted basis of partnership property is thus $3,000. Each partner's share in the adjusted basis of partnership property is one-third of this amount, or $1,000. Under the alternative rule, this amount represents each partner's adjusted basis for his partnership interest.

Example (2). Assume that partner A in example (1) of this paragraph sells his partnership interest to D for $1,250 at a time when the partnership property with an adjusted basis of $1,500 had appreciated in value to $3,000, and when the partnership also had $750 in cash. The total adjusted basis of all partnership property is $2,250 and the value of such property is $3,750. D's basis for his partnership interest is his cost, $1,250. However, his one-third share of the adjusted basis of partnership property is only $750. Therefore, for the purposes of the alternative rule, D has an adjustment of $500 in determining the basis of his interest. This amount represents the difference between the cost of his partnership interest and his share of partnership basis at the time of his purchase. If the partnership subsequently earns and retains an additional $1,500, its property will have an adjusted basis of $3,750. D's adjusted basis for his interest under the alternative rule is $1,750, determined by adding $500, his basis adjustment, to $1,250 (his one-third share of the $3,750 adjusted basis of partnership property). If the partnership distributes $250 to each partner in a current distribution, D's adjusted basis for his interest will be $1,500 ($1,000, his one-third share of the remaining basis of partnership property, $3,000, plus his basis adjustment of $500).

Example (3). Assume that BCD partnership in example (2) of this paragraph continues to operate. In 1960, D proposes to sell his partnership interest and wishes to evaluate the tax consequences of such sale. It is necessary, therefore, to determine the adjusted basis of his interest in the partnership. Assume further that D cannot determine the adjusted basis of his interest under the general rule. The balance sheet of the BCD partnership is as follows:

Assets	*Adjusted basis per books*	*Market value*
Cash	$3,000	$3,000
Receivables	4,000	4,000
Depreciable Property	5,000	5,000
Land held for investment	18,000	30,000
Total	$30,000	$42,000
Liabilities and Capital	*Per books*	
Liabilities	$6,000	
Capital Accounts: B	4,500	
C	4,500	
D	15,000	
Total	$30,000	

The $15,000 representing the amount of D's capital account does not reflect the $500 basis adjustment arising from D's purchase

of his interest. See example (2) of this paragraph. The adjusted basis of D's partnership interest determined under the alternative rule is a follows:

D's share of the adjusted basis of partnership property (reduced by the amount of liabilities) at time of proposed sale	$15,000
D's share of partnership liabilities (under the partnership agreement liabilities are shared equally)	2,000
D's basis adjustment from example (2)	500
Adjustment basis of D's interest at the time of proposed sale, as determined under alternative rule	$17,500

§ 1.706 STATUTORY PROVISIONS; TAXABLE YEARS OF PARTNER AND PARTNERSHIPS.

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 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.

§ 1.706-1 TAXABLE YEARS OF PARTNER AND PARTNERSHIP.—(a) *Years in which partnership income is includible.*—(1) In computing his taxable income for a taxable year, a partner is required to include his distributive share of partnership items set forth in section 702 for any partnership year ending within or with his taxable year. A partner shall also include in his taxable income for a taxable year "guaranteed payments" under section 707(c) which are made to him in a partnership taxable year ending within or with his taxable year. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A reports his income for a calendar year, while the partnership of which he is a member reports its income for a fiscal year ending May 31. During the partnership taxable year ending May 31, 1956, A received guaranteed payments of $1,200 for services and for the use of capital. Of this amount, $700 was received by A between June 1 and December 31, 1955, and the remaining $500 was received by him between January 1 and May 31, 1956. This entire $1,200 received by A is includible in his taxable income for the calendar year 1956 (together with his distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 1956).

(2) If a partner receives distributions under section 731 or sells or exchanges all or part of his partnership interest, any gain or loss arising therefrom does not constitute partnership income and is includible in the partner's gross income for his taxable year in which the payment is made. See sections 451 and 461.

(b) *Adoption or change in taxable year.*—(1) *Partnership taxable year.*—(i) The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

(ii) A newly formed partnership may adopt a taxable year which is the same as the taxable year of all its principal partners (or the same as the taxable year to which all of its principal partners are concurrently changing) without securing prior approval from the Commissioner, or it may adopt a calendar year without securing prior approval from the Commissioner if all its principal partners are not on the same taxable year. In any other case, a newly formed partnership must secure prior approval from the Commissioner for the adoption of a taxable year.

(iii) An existing partnership may not change its taxable year without securing prior approval from the Commissioner, unless all its principal partners have the same taxable year to which the partnership changes, or unless all its principal partners concurrently change to such taxable year.

(2) *Partner's taxable year.*—A partner may not change his taxable year without securing prior approval from the Commissioner. See section 442 and the regulations thereunder.

(3) *Principal partner.*—For the purpose of this paragraph, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(4) *Application for approval.*—(i) *Change.*—Application for a change in a taxable year shall be filed on Form 1128 with the Commissioner on or before the last day of the month following the close

of the short period for which a return is required to effect the change of taxable year.

(ii) *Adoption.*—Where a newly formed partnership is required to secure prior approval from the Commissioner for the adoption of a taxable year, the partnership shall file an application on Form 1128 with the Commissioner on or before the last day of the month following the close of the taxable year to be adopted. The partnership shall modify Form 1128 to the extent necessary to indicate that it is an application for adoption of a taxable year.

(iii) *Business purpose.*—Where prior approval is required under this paragraph, the applicant must establish a business purpose to the satisfaction of the Commissioner. For example, partnership AB, which is on a calendar year, is engaged in a business which has a natural business year (the annual accounting period encompassing all related income and expenses) ending on September 30th. The intention of the partnership to make its tax year coincide with such natural business year constitutes a sufficient business purpose.

(5) *Returns.*—(i) *Partner.*—A partner who changes his taxable year shall make his return for a short period in accordance with section 443, and shall attach to the return a copy of the letter from the Commissioner granting approval for the change of taxable year.

(ii) *Partnership.*—(*a*) A partnership which changes its taxable year shall make its return for a short period in accordance with section 443, but shall not annualize the partnership taxable income. The partnership shall attach to the return either a copy of the letter from the Commissioner granting approval of the change of taxable year, or a statement indicating that the partnership is changing its taxable year to the same taxable year as that of all its principal partners or to the same taxable year as that to which all its principal partners are concurrently changing.

(*b*) Any newly formed partnership shall file with its first return either:

(*1*) A copy of the letter from the Commissioner approving the adoption of a partnership taxable year which is not the same as the taxable year of all its principal partners; or

(*2*) A statement indicating that the taxable year it has adopted is the same as the taxable year of all its principal partners, or that all its principal partners are concurrently changing to the taxable year it has adopted; or

(*3*) A statement that all its principal partners are not on the same taxable year and that it is adopting a calendar year without prior approval.

(6) *Effective date.*—Section 706(b) applies to any partnership which adopts or changes to a taxable year beginning on or after April 2, 1954, and to any partner who changes to a taxable year beginning on or after that date. For the purpose of applying this provision, section 708 (relating to the continuation of a partnership) applies to any such taxable year. See section 771(b)(1) and § 1.771–1(b)(1). If a partnership has changed to or adopted, or if a partner has changed to, a taxable year beginning on or after April 2, 1954, without obtaining prior approval of the Commissioner, and if, under the provisions of this paragraph, prior approval is required for the change or adoption, such annual accounting period will not be ac-

cepted as a taxable year until approval thereof is secured. Under these circumstances, an application to change to or adopt the desired taxable year will be considered timely if filed within 90 days following the promulgation of the regulations under section 706.

(c) *Closing of partnership year.*—(1) *General rule.*—Section 706(c) and this paragraph provide rules governing the closing of partnership years. The closing of a partnership taxable year or a termination of a partnership for Federal income tax purposes is not necessarily governed by the "dissolution," "liquidation," etc., of a partnership under State or local law. 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 entire interest in the partnership (as defined in section 761(d)), or the sale or exchange of a partner's interest in the partnership, except in the case of a termination of a partnership and except as provided in subparagraph (2) of this paragraph. In the case of termination, the partnership taxable year closes for all partners as of the date of termination. See section 708(b) and § 1.708–1(b).

(2) *Partner who retires or sells interest in partnership.*—(i) *Disposition of entire interest.*—A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in a partnership, and with respect to a partner whose entire interest is liquidated. However, a partnership taxable year with respect to a partner who dies shall not close prior to the end of such partnership taxable year, or the time when such partner's interest (held by his estate or other successor) is liquidated or sold or exchanged, whichever is earlier. See subparagraph (3) of this paragraph.

(ii) *Inclusions in taxable income.*—In the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner shall include in his taxable income for his taxable year within or with which his membership in the partnership ends, his distributive share of items described in section 702(a), and any guaranteed payments under section 707(c), for his partnership taxable year ending with the date of such sale, exchange, or liquidation. In order to avoid an interim closing of the partnership books, such partner's distributive share of items described in section 702(a) may, by agreement among the partners, be estimated by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable. Any partner who is the transferee of such partner's interest shall include in his taxable income, as his distributive share of items described in section 702(a) with respect to the acquired interest, the pro rata part (determined by the method used by the transferor partner) of the amount of such items he would have included had he been a partner from the beginning of the taxable year of the partnership. The application of this subdivision may be illustrated by the following example:

Example. Assume that a partner selling his partnership interest on June 30, 1955, has an adjusted basis for his interest of $5,000 on that date; that his pro rata share of partnership income up to June 30 is $15,000; and that he sells his interest for $20,000.

Under the provisions of section 706(c)(2), the partnership year with respect to him closes at the time of the sale. The $15,000 is includible in his income as his distributive share and, under section 705, it increases the basis of his partnership interest to $20,000, which is also the selling price of his interest. Therefore, no gain is realized on the sale of his partnership interest. The purchaser of this partnership interest shall include in his income as his distributive share his pro rata part of partnership income for the remainder of the partnership taxable year.

(3) *Partner who dies.*—(i) When a partner dies, the partnership taxable year shall not close with respect to such partner prior to the end of the partnership taxable year. The partnership taxable year shall continue both for the remaining partners and the decedent partner. Where the death of a partner results in the termination of the partnership, the partnership taxable year shall close for all partners on the date of such termination under section 708(b)(1)(A). See also § 1.708–1(b)(1)(i)(*b*) for the continuation of a 2-member partnership under certain circumstances after the death of a partner. However, if the decedent partner's estate or other successor sells or exchanges its entire interest in the partnership, or if its entire interest is liquidated, the partnership taxable year with respect to the estate or other successor in interest shall close on the date of such sale or exchange, or the date of completion of the liquidation.

(ii) The last return of a decedent partner shall include only his share of partnership taxable income for any partnership taxable year or years ending within or with the last taxable year for such decedent partner (i. e., the year ending with the date of his death). The distributive share of partnership taxable income for a partnership taxable year ending after the decedent's last taxable year is includible in the return of his estate or other successor in interest. If the estate or other successor in interest of a partner continues to share in the profits or losses of the partnership business, the distributive share thereof is includible in the taxable year of the estate or other successor in interest within or with which the taxable year of the partnership ends. See also § 1.736–1(a)(1)(ii). Where the estate or other successor in interest receives distributions, any gain or loss on such distributions is includible in its gross income for its taxable year in which the distribution is made.

(iii) If a partner (or a retiring partner), in accordance with the terms of the partnership agreement, designates a person to succeed to his interest in the partnership after his death, such designated person shall be regarded as a successor in interest of the deceased for purposes of this chapter. Thus, where a partner designates his widow as the successor in interest, her distributive share of income for the taxable year of the partnership ending within or with her taxable year may be included in a joint return in accordance with the provisions of sections 2 and 6013(a)(2) and (3).

(iv) If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent partner's interest in the partnership occurs upon that date, then the taxable year of the partnership with respect to such decedent partner shall close upon the date of death. See section 706(c)(2)(A)(i). The sale or exchange of a partnership interest does not, for the purpose of this

rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition.

(v) To the extent that any part of a distributive share of partnership income of the estate or other successor in interest of a deceased partner is attributable to the decedent for the period ending with the date of his death, such part of the distributive share is income in respect of the decedent under section 691. See section 691 and the regulations thereunder.

(vi) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). B has a taxable year ending December 31 and is a member of partnership ABC, the taxable year of which ends on June 30. B dies on October 31, 1955. His estate (which as a new taxpayer may, under section 441 and the regulations thereunder, adopt any taxable year) adopts a taxable year ending October 31. The return of the decedent for the period January 1 to October 31, 1955, will include only his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955. The distributive share of taxable income of the partnership for its taxable year ending June 30, 1956, arising from the interest of the decedent, will be includible in the return of the estate for its taxable year ending October 31, 1956. That part of the distributive share attributable to the decedent for the period ending with the date of his death (July 1 through October 31, 1955) is income in respect of a decedent under section 691.

Example (2). Assume the same facts as in example (1) of this subdivision, except that, prior to B's death, B and D had agreed that, upon B's death, D would purchase B's interest for $10,000. When B dies on October 31, 1955, the partnership taxable year beginning July 1, 1955, closes with respect to him. Therefore, the return for B's last taxable year (January 1 to October 31, 1955) will include his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955, plus his distributive share of partnership taxable income for the period July 1 to October 31, 1955. See subdivision (iv) of this subparagraph.

Example (3) H is a member of a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file joint returns. H dies on March 31, 1955. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 1955. Such distribution by the estate is not a sale or exchange of H's partnership interest. No part of the taxable income of the partnership for the taxable year ending December 31, 1955, which is allocable to H, will be included in H's taxable income for his last taxable year (January 1 through March 31, 1955) or in the taxable income of H's estate for the taxable year April 1 through November 30, 1955. The distributive share of partnership taxable income for the full calendar year that is allocable to H will be includible in the taxable income of W for her taxable year ending December 31, 1955, and she may file a joint return under sections 2 and 6013(a)(3).

That part of the distributive share attributable to the decedent for the period ending with the date of his death (January 1 through March 31, 1955) is income in respect of a decedent under section 691.

Example (4). M is a member of partnership JKM which operates on a calendar year. M and his wife S file joint returns for calendar years. In accordance with the partnership agreement, M designated S to succeed to his interest in the partnership upon his death. M, who had withdrawn $10,000 from the partnership before his death, dies on October 20, 1955. S's distributive share of income for the taxable year 1955 is $15,000 ($10,000 of which represents the amount withdrawn by M). S shall include $15,000 in her income, even though M received $10,000 of this amount before his death. S may file a joint return with M for the year 1955 under sections 2 and 6013(a). That part of the $15,000 distributive share attributable to the decedent for the period ending with the date of his death (January 1 through October 20, 1955) is income in respect of a decedent under section 691.

(4) *Disposition of less than entire interest.*—If a partner sells or exchanges a part of his interest in a partnership, or if the interest of a partner is reduced, the partnership taxable year shall continue to its normal end. In such case, the partner's distributive share of items which he is required to include in his taxable income under the provisions of section 702(a) shall be determined by taking into account his varying interests in the partnership during the partnership taxable year in which such sale, exchange, or reduction of interest occurred.

(5) *Transfer of interest by gift.*—The transfer of a partnership interest by gift does not close the partnership taxable year with respect to the donor. However, the income up to the date of gift attributable to the donor's interest shall be allocated to him under section 704(e)(2).

§ 1.707 Statutory Provisions; Transactions Between Partner and Partnership.

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).

§ 1.707–1 TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP—(a) *Partner not acting in capacity as partner.*—A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership, the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership. Where a partner retains the ownership of property but allows the partnership to use such separately owned property for partnership purposes (for example, to obtain credit or to secure firm creditors by guaranty, pledge, or other agreement) the transaction is treated as one between a partnership and a partner not acting in his capacity as a partner. However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions included within the provisions of this section. In all cases, the substance of the transaction will govern rather than its form. See § 1.731–1(c)(3).

(b) *Certain sales or exchanges of property with respect to controlled partnerships.*—(1) *Losses disallowed.*—(i) No deduction shall be allowed for a loss on a sale or exchange of property (other than an interest in the partnership), directly or indirectly, between a partnership and a partner who owns, directly or indirectly, more than 50 percent of the capital interest or profits interest in such partnership. A loss on a sale or exchange of property, directly or indirectly, between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interest or profits interests in each partnership shall not be allowed.

(ii) If a gain is realized upon the subsequent sale or exchange by a transferee of property with respect to which a loss was disallowed under the provisions of subdivision (i) of this subparagraph, section 267(d) (relating to amount of gain where loss previously disallowed)

shall apply as though the loss were disallowed under section 267(a)(1).

(2) *Gains treated as ordinary income.*—Any gain recognized upon the sale or exchange, directly or indirectly, of property which, in the hands of the transferee immediately after the transfer, is property other than a capital asset, as defined in section 1221, shall be ordinary income if the transaction is between a partnership and a partner who owns, directly or indirectly, more than 80 percent of the capital interest or profits interest in the partnership. This rule also applies where such a transaction is between partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital interests or profits interests in each partnership. The term "property other than a capital asset" includes (but is not limited to) trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade or business.

(3) *Ownership of capital or profits interest.*—For the purpose of section 707(b) and this paragraph, the ownership of a capital interest or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c)(1), (2), (4), and (5). Under these rules, ownership of a capital or profits interest in a partnership may in certain circumstances be attributed to a person who is not a partner as defined in section 761(b).

(c) *Guaranteed payments.*—Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and § 1.706–1(a). Guaranteed payments are considered as made to one who is not a member of the partnership, only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). They do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the

partnership taxable years ends ($10,000 guaranteed payment plus $5,000 distributive share).

Example (2). Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Example (3). Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.

Example (4). Assume the same facts as in example (3) of this paragraph except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30-percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

§ 1.708 Statutory Provisions; Continuation of Partnership.

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 thon 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.

§ 1.708–1 CONTINUATION OF PARTNERSHIP.—(a) *General rule.*—For purposes of subchapter K, an existing partnership shall be considered as continuing if it is not terminated.

(b) *Termination.*—(1) *General rule.*—(i) A partnership shall terminate when the operations of the partnership are discontinued and 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. For example, on November 20, 1956, A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of November 20, 1956. However, where partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957.

(*a*) Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.

(*b*) For the continuation of a partnership where payments are being made under section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), see § 1.736–1(a)(6).

(ii) A partnership shall terminate when 50 percent or more of the total interest in partnership capital and profits is sold or exchanged within a period of 12 consecutive months. Such sale or exchange includes a sale or exchange to another member of the partnership. However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange for purposes of this subparagraph. Furthermore, the contribution of property to a partnership does not constitute such a sale or exchange. See, however, § 1.731–1(c)(3). Fifty percent or more of the total interest in partnership capital and profits means 50 percent or more of the total interest in partnership capital plus 50 percent or more of the total interest in partnership profits. Thus, the sale of a 30-percent interest in partnership capital and a 60-percent interest in partnership profits is not the sale or exchange of 50 percent or more of the total interest in partnership capital and profits. If one or more partners sell or exchange interests aggregating 50 percent or more of the total interest in partnership capital and 50 percent or more of the total interest in partnership profits within a period of 12 consecutive months, such sale or exchange is considered as being within the provisions of this subparagraph. When interests are sold or exchanged on different dates, the percentages to be added are determined as of the date of each sale. For example, with respect to the ABC partnership, the sale by A on May 12, 1956, of a 30-percent interest in capital and profits to D, and the sale by B on March 27, 1957, of a 30-percent interest in capital and profits to E, is a sale of a 50-percent or more interest. Accordingly, the partnership is terminated as of March 27, 1957. However, if on March 27, 1957, D, instead of B, sold his 30-percent

interest in capital and profits to E, there would be no termination since only one 30-percent interest would have been sold or exchanged within a 12-month period.

(iii) For purposes of subchapter K, a partnership taxable year closes with respect to all partners on the date on which the partnership terminates. See section 706(c)(1) and § 1.706–1(c)(1). The date of termination is:

(*a*) For purposes of section 708(b)(1)(A), the date on which the winding up of the partnership affairs is completed.

(*b*) For purposes of section 708(b)(1)(B), the date of the sale or exchange of a partnership interest which, of itself or together with sales or exchanges in the preceding 12 months, transfers an interest of 50 percent or more in both partnership capital and profits.

(iv) If a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership distributes its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properties; and, immediately thereafter, the purchaser and the other remaining partners contribute the properties to a new partnership, either for the continuation of the business or for its dissolution and winding up. In the latter case, the new partnership terminates in accordance with subdivision (i) of this subparagraph. See sections 731 and 732 and §§ 1.731–1 and 1.732–1. For election of basis adjustments by the purchaser and other remaining partners, see sections 732(d) and 743(b) and §§ 1.732–1(d) and 1.743–1(b).

(2) *Special rules.*—(i) *Merger or consolidation.*—If two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more that 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can, under the preceding sentence, be considered a continuation of more than one of the merging or consolidating partnerships, it shall, unless the Commissioner permits otherwise, be considered the continuation of that partnership which is credited with the contribution of the greatest dollar value of assets to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated. If the members of none of the merging or consolidating partnerships have an interest of more than 50 percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results. The taxable years of such merging or consolidating partnerships which are considered terminated shall be closed in accordance with the provisions of section 706(c), and such partnerships shall file their returns for a taxable year ending upon the date of termination, i. e., the date of merger or consolidation. The resulting partnership shall file a return for the taxable year of the merging or consolidating partnership that is considered as continuing. The return shall state that the resulting partnership is a continuation of such merging or consolidating partnership and shall include the names and addresses of the merged or consolidated partnerships. The respective distributive shares of the partners for the periods prior to and subsequent to the date of merger or consolidation shall be shown

as a part of the return. The provisions of this subdivision may be illustrated by the following example:

Example. Partnership AB, in whose capital and profits A and B each own a 50-percent interest, and partnership CD, in whose capital and profits C and D each own a 50-percent interest, merge on September 30, 1955, and form partnership ABCD. Partners A, B, C, and D are on a calendar year; partnership AB is also on a calendar year; and partnership CD is on a fiscal year ending June 30th. After the merger, the partners have capital and profits interests as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent. Since A and B together own an interest of more than 50 percent in the capital and profits of partnership ABCD, such partnership shall be considered a continuation of partnership AB and shall continue to file returns on a calendar year basis. Since C and D own an interest of less than 50 percent in the capital and profits of partnership ABCD, the taxable year of partnership CD closes as of September 30, 1955, the date of the merger, and CD partnership is terminated as of that date. Partnership ABCD is required to file a return for the taxable year January 1 to December 31, 1955, indicating thereon that, until September 30, 1955, it was partnership AB. Partnership CD is required to file a return for its final taxable year, July 1 through September 30, 1955.

(ii) *Division of a partnership.*—Upon the division of a partnership into two or more partnerships, any resulting partnership or partnerships shall be considered a continuation of the prior partnership if its members had an interest of more than 50 percent in the capital and profits of the prior partnership. Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership. If the members of none of the resulting partnerships owned an interest of more than 50 percent in the capital and profits of the divided partnership, the divided partnership is terminated. Where members of a partnership which has been divided into two or more partnerships do not become members of a resulting partnership which is considered a continuation of the prior partnership, such partner's interest shall be considered liquidated as of the date of the division. The resulting partnership that is regarded as continuing shall file a return for the taxable year of the partnership that has been divided. The return shall state that the partnership is a continuation of the divided partnership and shall set forth separately the respective distributive shares of the partners for the periods prior to and subsequent to the date of division. The provisions of this subdivision may be illustrated by the following example:

Example. Partnership ABCD is in the real estate and insurance business. A owns a 40-percent interest, and B, C, and D each owns a 20-percent interest, in the capital and profits of the partnership. The partnership and the partners report their income on a calendar year. They agree to separate the real estate and insurance business as of November 1, 1955, and to form two partnerships; partnership AB to take over the real estate business, and partnership CD to take over the insurance business. Since members of resulting partnership AB owned more than a

50-percent interest in the capital and profits of partnership ABCD (A, 40 percent, and B, 20 percent), partnership AB shall be considered a continuation of partnership ABCD. Partnership AB is required to file a return for the taxable year January 1 to December 31, 1955, indicating thereon that until November 1, 1955, it was partnership ABCD. In forming partnership CD, partners C and D may contribute the property distributed to them in liquidation of their entire interests in divided partnership ABCD. Partnership CD will be required to file a return for the taxable year it adopts pursuant to section 706(b) and § 1.706–1(b).

CONTRIBUTIONS, DISTRIBUTIONS, AND TRANSFERS

Contributions to a Partnership

§ 1.721 STATUTORY PROVISIONS; NONRECOGNITION OF GAIN OR LOSS ON CONTRIBUTION.

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.

§ 1.721–1 NONRECOGNITION OF GAIN OR LOSS ON CONTRIBUTION.—(a) No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating. Section 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See § 1.731–1(c)(3). Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721. For the rules governing the treatment of liabilities to which contributed property is subject, see section 752 and § 1.752–1.

(b)(1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in

capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is: (i) compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707(c); (ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.

§ 1.722 STATUTORY PROVISIONS; BASIS OF CONTRIBUTING PARTNER'S INTEREST.

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.

§ 1.722–1 BASIS OF CONTRIBUTING PARTNER'S INTEREST.—The basis to a partner of a partnership interest acquired by a contribution of property, including money, to the partnership shall be the amount of money contributed plus the adjusted basis at the time of contribution of any property contributed. If the acquisition of an interest in partnership capital results in taxable income to a partner, such income shall constitute an addition to the basis of the partner's interest. See § 1.721–1(b). If the contributed property is subject to indebtedness or if liabilities of the partner are assumed by the partnership, the basis of the contributing partner's interest shall be reduced by the portion of the indebtedness assumed by the other partners, since the partnership's assumption of his indebtedness is treated as a distribution of money to the partner. Conversely, the assumption by the other partners of a portion of the contributor's indebtedness is treated as a contribution of money by them. See section 752 and § 1.752–1. The provisions of this section may be illustrated by the following examples:

Example (1). A acquired a 20-percent interest in a partnership by contributing property. At the time of A's contribution, the property had a fair market value of $10,000, an adjusted basis to A of $4,000, and was subject to a mortgage of $2,000. Payment of the mortgage was assumed by the partnership. The basis of A's interest in the partnership is $2,400, computed as follows:

Adjusted basis to A of property contributed	$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80% of $2,000)	1,600
Basis of A's interest	$2,400

Example (2). If, in example (1) of this section, the property contributed by A was subject to a mortgage of $6,000, the basis of A's interest would be zero, computed as follows:

Adjusted basis to A of property contributed	$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80% of $6,000)	4,800
	($800)

Since A's basis cannot be less than zero, the $800 in excess of basis, which is considered as a distribution of money under section 752(b), is treated as capital gain from the sale or exchange or a partnership interest. See section 731(a).

§ 1.723 STATUTORY PROVISIONS; BASIS OF PROPERTY CONTRIBUTED TO PARTNERSHIP.

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.

§ 1.723-1 BASIS OF PROPERTY CONTRIBUTED TO PARTNERSHIP.—The basis to the partnership of property contributed to it by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution. Since such property has the same basis in the hands of the partnership as it had in the hands of the contributing partner, the holding period of such property for the partnership includes the period during which it was held by the partner. See section 1223(2). For elective adjustments to the basis of partnership property arising from distributions or transfers of partnership interests, see section 732(d), 734(b), and 743(b).

Distributions by a Partnership

§ 1.731 STATUTORY PROVISIONS; EXTENT OF RECOGNITION OF GAIN OR LOSS ON DISTRIBUTION.

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).

§ 1.731-1 EXTENT OF RECOGNITION OF GAIN OR LOSS ON DISTRIBUTION—(a) *Recognition of gain or loss to partner.*—(1) *Recognition of gain.*—(i) Where money is distributed by a partnership to a partner, no gain shall be recognized to the partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. This rule is applicable both to current distributions (i. e., distributions other than in liquidation of an entire interest) and to distributions in liquidation of a partner's entire interest in a partnership. Thus, if a partner with a basis for his interest of $10,000 receives a distribution of cash of $8,000 and property with a fair market value of $3,000, no gain is recognized to him. If $11,000 cash were distributed, gain would be recognized to the extent of $1,000. No gain shall be recognized to a distributee partner with respect to a distribution of property (other than money) until he sells or otherwise disposes of such property, except 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). See section 731(c) and paragraph (c) of this section.

(ii) For the purposes of sections 731 and 705, advances or drawings of money or property against a partner's distributive share of income shall be treated as current distributions made on the last day of the partnership taxable year with respect to such partner.

(2) *Recognition of loss.*—Loss is recognized to a partner only upon liquidation of his entire interest in the partnership, and only if the property distributed to him consists solely of money, unrealized receivables (as defined in section 751(c)), and inventory items (as defined in section 751(d)(2)). The term "liquidation of a partner's interest", as defined in section 761 (d), is the termination of the partner's entire interest in the partnership by means of a distribution or a series of distributions. Loss is recognized to the distributee partner in such cases to the extent of the excess of the adjusted basis of such partner's interest in the partnership at the time of the distribution over the sum of—

(i) Any money distributed to him, and

(ii) The basis to the distributee, as determined under section 732, of any unrealized receivables and inventory items that are distributed to him.

If the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory items, then no loss will be recognized. Application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner A has a partnership interest in partnership ABC with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $5,000 cash and inventory with a basis to him (under section 732) of $3,000. Partner A realizes a capital loss of $2,000, which is recognized under section 731(a)(2).

Example (2). Partner B has a partnership interest in partnership BCD with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $4,000 cash, real property (used in the trade or business) with an adjusted basis to the partnership of $2,000, and unrealized receivables having a basis to him (under section 732) of $3,000. No loss will be recognized to B on the transaction because he received property other than money, unrealized receivables, and inventory items. As determined under section 732, the basis to B for the real property received is $3,000.

(3) *Character of gain or loss.*—Gain or loss recognized under section 731(a) on a distribution is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner, that is, capital gain or loss.

(b) *Gain or loss recognized by partnership.*—A distribution of property (including money) by a partnership to a partner does not result in recognized gain or loss to the partnership under section 731. However, recognized gain or loss may result to the partnership from certain distributions which, under section 751(b), must be treated as a sale or exchange of property between the distributee partner and the partnership.

(c) *Exceptions.*—(1) Section 731 does not apply to the extent otherwise provided by—

(i) Section 736 (relating to payments to a retiring partner or to a deceased partner's successor in interest), and

(ii) Section 751 (relating to unrealized receivables and inventory items).

For example, payments under section 736(a), which are considered as a distributive share or guaranteed payment, are taxable as such under that section.

(2) The receipt by a partner from the partnership of money or property under an obligation to repay the amount of such money or to return such property does not constitute a distribution subject to section 731 but is a loan governed by section 707(a). To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation.

(3) If there is a contribution of property to a partnership and within a short period:

(i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or

(ii) After such contribution the contributed property is distributed to another partner,

such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property.

§ 1.732 STATUTORY PROVISIONS; BASIS OF DISTRIBUTED PROPERTY OTHER THAN MONEY.

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) DISTRIBUTION 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 allocated—

(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).

§ 1.732–1 BASIS OF DISTRIBUTED PROPERTY OTHER THAN MONEY.—(a) *Distributions other than in liquidation of a partner's interest.*—The basis of property (other than money) received by a partner in a distribution from a partnership, other than in liquidation of his entire interest, shall be its adjusted basis to the partnership immediately before such distribution. However, the basis of the property to the partner shall not exceed the adjusted basis of the partner's interest in the partnership, reduced by the amount of any money distributed to him in the same transaction. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Partner A, with an adjusted basis of $15,000 for his partnership interest, receives in a current distribution property

having an adjusted basis of $10,000 to the partnership immediately before distribution, and $2,000 cash. The basis of the property in A's hands will be $10,000. Under sections 733 and 705, the basis of A's partnership interest will be reduced by the distribution to $3,000 ($15,000, less $2,000 cash, less $10,000, the basis of the distributed property to A).

Example (2). Partner R has an adjusted basis of $10,000 for his partnership interest. He receives a current distribution of $4,000 cash and property with an adjusted basis to the partnership of $8,000. The basis of the distributed property to partner R is limited to $6,000 ($10,000, the adjusted basis of his interest, reduced by $4,000, the cash distributed).

(b) *Distribution in liquidation.*—Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him in the same transaction. Application of this rule may be illustrated by the following example:

Example. Partner B, with a partnership interest having an adjusted basis to him of $12,000, retires from the partnership and receives cash of $2,000, and real property with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000. The basis of the real property to B is $10,000 (B's basis for his partnership interest, $12,000, reduced by $2,000, the cash distributed).

(c) *Allocation of basis among properties distributed to a partner.*—(1) Under section 732(a)(2) or (b), the basis to be allocated to properties distributed to a partner shall be allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) included in the distribution. However, such receivables or inventory items may not take a higher basis in the hands of the partner than their common adjusted basis to the partnership immediately before the distribution, unless such distribution is treated as a sale or exchange under section 751(b), or unless the distributee partner has a special basis adjustment for the distributed property under sections 732(d) or 743(b). Any basis not allocated to unrealized receivable or inventory items shall be allocated to any other properties distributed to the partner in the same transaction, in proportion to the bases of such other properties in the hands of the partnership before distribution. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A, whose partnership interest in partnership ABC has an adjusted basis of $15,000, receives as a distribution in liquidation of his entire interest inventory items having a basis to the partnership of $6,000. In addition, he receives cash of $5,000, and two parcels of real property with adjusted bases to the partnership of $6,000 and $2,000, respectively. Basis in the amount of $10,000 ($15,000 basis, less $5,000 cash received) is allocated $6,000 to inventory items, and $3,000 (6,000/8,000 × $4,000) and $1,000 (2,000/8,000 × $4,000), respectively, to the two parcels of real property.

(2) If the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to a partner is greater than the partner's adjusted basis of his interest (reduced by the amount of money distributed to him in the same transaction), the amount of the basis to be allocated to such unrealized receivables and inventory items shall be allocated in proportion to the adjusted bases of such properties in the hands of the partnership. If the basis of the partner's interest to be allocated upon a distribution in liquidation of his entire interest is in excess of the adjusted basis to the partnership of the unrealized receivables and inventory items distributed, and if there is no other property distributed to which such excess can be allocated, the distributee partner sustains a capital loss under section 731(a)(2) to the extent of the unallocated basis of his partnership interest. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner C, whose interest in partnership ABC has an adjusted basis to him of $9,000, receives as a distribution in liquidation cash of $6,000, inventory items having an adjusted basis to the partnership of $6,000, and real property having a basis to the partnership of $4,000. The cash payment reduces C's basis to $3,000, which is allocated entirely to inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under section 754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under section 734(b).

Example (2). Partner B, whose interest in partnership ABC has an adjusted basis to him of $9,000, receives as a distribution in liquidation cash of $1,000 and inventory items having a basis to the partnership of $6,000. The cash payment reduces B's basis to $8,000, which can be allocated only to the extent of $6,000 to the inventory items. The remaining $2,000 basis, not allocable to distributed property, constitutes a capital loss in that amount to partner B under section 731(a)(2). If the election under section 754 is in effect, see section 734(b) for adjustment of the basis of undistributed partnership property.

(d) *Special partnership basis to transferee under section 732(d).* (1)(i) A transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner. Section 732(d) provides a special rule for the determination of the basis of property distributed to a transferee partner who acquired any part of his partnership interest in a transfer with respect to which the election under section 754 (relating to the optional adjustment to basis of partnership property) was not in effect.

(ii) Where an election under section 754 is in effect, see section 743(b) and §§ 1.743–1(b) and 1.732–2.

(iii) If a transferee partner receives a distribution of property (other than money) from the partnership within 2 years after he acquired his interest or part thereof in the partnership by a transfer with respect to which the election under section 754 was not in effect, he may elect 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.

(iv) If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation on that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

(v) If property is distributed to a transferee partner who elects under section 732(d), and if such property is not the same property which would have had a special basis adjustment, then such special basis adjustment shall apply to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment. This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed of by the partnership. (For shift of transferee's special basis adjustment to like property, see § 1.743–1(b)(2)(ii).)

(vi) The provisions of this subparagraph may be illustrated by the following example:

Example. The basis to transferee partner K of his one-fourth interest in partnership WJKS is $17,000. At the time he acquired such interest by purchase, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of $14,000 and a value of $16,000. K's purchase price reflected $500 of this difference. Thus, $4,000 of the $17,000 paid by K for his one-fourth interest was attributable to his share of partnership inventory with a basis of $3,500. Within 2 years after acquiring his interest, K retired from the partnership and received in liquidation of his entire interest cash of $1,500, inventory with a basis to the partnership of $3,500, property X (a capital asset), with an adjusted basis to the partnership of $2,000, and property Y (a depreciable asset), with an adjusted basis to the partnership of $4,000. The value of the inventory received by K was one-fourth of the value of all partnership inventory and was his share of such property. It is immaterial whether the inventory K received was on hand when K acquired his interest. In accordance with K's election under section 732(d), the amount of his share of partnership basis which is attributable to partnership inventory is increased by $500 (one-fourth of the $2,000 difference between the value of such property, $16,000, and its $14,000 basis to the partnership at the time K acquired his interest). This adjustment under section 732(d) applies only for purposes of distributions to partner K, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by K in the liquidating distribution is $15,500 ($17,000, K's basis for his interest, reduced by the amount of cash received, $1,500). This amount is allocated as follows: The basis of the inventory items received is $4,000, consisting of the $3,500 common partnership basis for such items, plus the special basis adjustment of $500 which K would have had under section 743(b). The re-

maining basis of $11,500 ($15,500 minus $4,000) is to be allocated to the remaining property distributed to K in proportion to their adjusted bases to the partnership. Since the adjusted basis to the partnership of property X is $2,000, and that of property Y is $4,000, the $11,500 is allocated $3,833 (2,000/6,000 × $11,500) to X, and $7,667 (4,000/6,000 × $11,500) to Y.

(2) A transferee partner who wishes to elect under section 732(d) shall make the election with his tax return—

(i) For the year of the distribution, if the distribution includes any property subject to the allowance for depreciation, depletion, or amortization, or

(ii) For any taxable year no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax, if the distribution does not include any such property subject to the allowance for depreciation, depletion or amortization.

(3) A taxpayer making an election under section 732(d) shall submit with the return in which the election is made a schedule setting forth the following:

(i) That under section 732(d) he elects to adjust the basis of property received in a distribution; and

(ii) The computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated. For rules of allocation, see section 755.

(4) A partner who acquired any part of his partnership interest in a transfer to which the election provided in section 754 was not in effect, is required to apply the special basis rule contained in section 732(d) to a distribution to him, whether or not made within 2 years after the transfer, if at the time of his acquisition of the transferred interest—

(i) The fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership,

(ii) An allocation of basis under section 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

(iii) A special basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.

The application of this rule may be illustrated by the following examples:

Example (1). Partnership ABC owns three parcels of land, each of which has an adjusted basis to the partnership of $5,000 and is worth $55,000, and depreciable property with an adjusted basis and value of $150,000. D purchases A's partnership interest for $105,000 when the election under section 754 is not in effect. At the time of D's purchase, the fair market value of all partnership property (other than money) is $315,000, which exceeds 110 percent of $165,000, its adjusted basis to the partnership. Four years later, the partnership is dissolved. D receives one of the three parcels of land which has a basis to the partner-

ship of $5,000, and one-third of the depreciable property with an adjusted basis to the partnership at that time of $45,000, one-third of $135,000 ($150,000 basis, minus $15,000 depreciation computed on the partnership basis. See subparagraph (1)(iv) of this paragraph.) If D's adjusted basis for his interest at the time of the distribution was $100,000 and was allocated under section 732(c) to the property received by him in proportion to their respective bases to the partnership, the basis to him for the distributed land would be $10,000 (5,000/50,000×$100,000) and the basis of the depreciable property would be $90,000 (45,000/50,000×$100,000). In effect, D would be attributing to the basis of the depreciable property a portion of the cost of his partnership interest properly attributable to appreciation in nondepreciable property. The application of section 743(b) to the transfer of the interest would have resulted in a different basis to D for the property actually distributed. Therefore, the special basis adjustment under section 732(d) must be made so that D must increase the basis of the land by a special basis adjustment of $50,000 ($55,000 fair market value less $5,000 partnership basis), making the basis of his interest therein $55,000 (55,000/100,000×$100,000). D's basis for the depreciable property will then be $45,000 (45,000/100,000×$100,000).

Example (2). Assume the facts as in example (1) of this subparagraph, except that the partnership does not dissolve but distributes one parcel of land to each of the partners in a current distribution. Since the conditions of this subparagraph have been met, D's basis for the distributed land is the adjusted basis such land would have if the adjustment provided in section 743(b) were in effect with respect to the partnership property. Therefore, D's basis for the land is $55,000 ($5,000 basis of the land to the partnership, plus $50,000 special basis adjustment under section 732(d)). D's basis for his partnership interest is reduced by $55,000, his basis for the property distributed.

(e) *Exception.*—When a partnership distributes unrealized receivables (as defined in section 751(c)) or substantially appreciated inventory items (as defined in section 751(d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of section 751(b). In such case, section 732 (including subsection (d) thereof) applies in determining the partner's basis of the property which he is treated as having sold to or exchanged with the partnership (as constituted after the distribution). The partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it. See section 751(b) and § 1.751–1(b). However, section 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by him in a sale or exchange under section 751(b). Consequently, the basis of such property shall be its cost to the partner.

§ 1.732–2 Special Partnership Basis of Distributed Property.—(a) *Adjustments under section* 734(b).—In the case of a distribution of property to a partner, the partnership bases of the distributed properties shall reflect any increases or decreases to the basis of partnership property which have been made previously under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) in connection with previous distributions.

(b) *Adjustments under section* 743(b).—In the case of a distribution of property to a partner who acquired any part of his interest in a transfer as to which an election under section 754 was in effect, then, for the purposes of section 732 (other than subsection (d)), the adjusted partnership bases of the distributed property shall take into account, in addition to any adjustments under section 734(b), the transferee's special basis adjustment for the distributed property under section 743(b). The application of this paragraph may be illustrated by the following example:

Example. Partner D acquired his interest in partnership ABD from a previous partner. Since the partnership had made an election under section 754, a special basis adjustment with respect to D is applicable to the basis of partnership property in accordance with section 743(b). One of the assets of the partnership at the time D acquired his interest was property X, which is later distributed to D in a current distribution. Property X has an adjusted basis to the partnership of $1,000 and with respect to D it has a special basis adjustment of $500. Therefore, for purposes of section 732(a)(1), the adjusted basis of such property to the partnership with respect to D immediately before its distribution is $1,500. However, if property X is distributed to partner A, a nontransferee partner, its adjusted basis to the partnership for purposes of section 732(a)(1) is only $1,000. In such case, D's $500 special basis adjustment may shift over to other property. See § 1.743–1(b)(2)(ii).

(c) *Adjustments to basis of distributed inventory and unrealized receivables.*—Under section 732, the basis to be allocated to distributed properties shall be allocated first to any unrealized receivables and inventory items. If the distributee partner is a transferee of a partnership interest and has a special basis adjustment for unrealized receivables or inventory items under either section 743(b) or section 732(d), then the partnership adjusted basis immediately prior to distribution of any unrealized receivables or inventory items distributed to such partner shall be determined as follows: If the distributee partner receives his entire share of the fair market value of the inventory items or unrealized receivables of the partnership, the adjusted basis of such distributed property to the partnership, for the purposes of section 732, shall take into account the entire amount of any special basis adjustment which the distributee partner may have for such assets. If the distributee partner receives less than his entire share of the fair market value of partnership inventory items or unrealized receivables, then, for purposes of section 732, the adjusted basis of such distributed property to the partnership shall take into account the same proportion of the distributee's special basis adjustment for unrealized receivables or inventory items as the value of such items distributed to him bears to his entire share of the total value of all such items of the partnership. The provisions of this paragraph may be illustrated by the following example:

Example. Partner C acquired his 40-percent interest in partnership AC from a previous partner. Since the partnership had made an election under section 754, C has a special basis adjustment to partnership property under section 743(b). C retires from the partnership when the adjusted basis of his partnership interest is $3,000. He receives from the partnership in liquidation of his entire interest, $1,000 cash, certain capital assets, depreciable property, and certain inventory items and unrealized receivables. C has a special basis adjustment of $800 with respect to partnership inventory items and of $200 with respect to unrealized receivables. The common partnership basis for the inventory items distributed to him is $500 and for the unrealized receivables is zero. If the value of inventory items and the unrealized receivables distributed to C in his 40-percent share of the total value of all partnership inventory items and unrealized receivables, then, for purposes of section 732, the adjusted basis of such property in C's hands will be $1,300 for the inventory items ($500 plus $800) and $200 for the unrealized receivables (zero plus $200). The remaining basis of $500, which constitutes the basis of the capital assets and depreciable property distributed to C, is determined as follows: $3,000 (total basis) less $1,000 cash, or $2,000 (the amount to be allocated to the basis of all distributed property), less $1,500 ($800 and $200 special basis adjustments, plus $500 common partnership basis, the amount allocated to inventory items and unrealized receivables). However, if the value of the inventory items and unrealized receivables distributed to C consisted of only 20 percent of the total fair market value of such property (i. e., only one-half of C's 40-percent share), then only one-half of C's special basis adjustment of $800 for partnership inventory items and $200 for unrealized receivables would be taken into account. In that case, the basis of the inventory items in C's hands would be $650 ($250, the common partnership basis for inventory items distributed to him, plus $400, one-half of C's special basis adjustment for inventory items). The basis of the unrealized receivables in C's hands would be $100 (zero plus $100, one-half of C's special basis adjustment for unrealized receivables).

§ 1.733 Statutory Provisions; Basis of Distributee Partner's Interest.

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.

§ 1.733–1 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 entire interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by the amount of any money distributed to such partner and by the

amount of the basis to him of distributed property other than money as determined under section 732 and §§ 1.732–1 and 1.732–2.

§ 1.734 STATUTORY PROVISIONS; OPTIONAL ADJUSTMENT TO BASIS OF UNDISTRIBUTED PARTNERSHIP PROPERTY.

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.

§ 1.734–1 OPTIONAL ADJUSTMENT TO BASIS OF UNDISTRIBUTED PARTNERSHIP PROPERTY.—(a) *General rule.*—A partnership shall not adjust the basis of partnership property 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.

(b) *Method of adjustment.*—(1) *Increase in basis.*—Where an election under section 754 is in effect and a distribution of partnership property is made, whether or not in liquidation of the partner's entire interest in the partnership, the adjusted basis of the remaining partnership assets shall be increased by—

(i) The amount of any gain recognized under section 731(a)(1) to the distributee partner, or

(ii) The excess of the adjusted basis to the partnership immediately before the distribution of any property distributed (including adjustments under section 743(b) or section 732(d) when applied) over the basis under section 732 (including such special basis adjustments) of such property to the distributee partner.

The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner A has a basis of $10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of $11,000 and property with a partnership basis of $19,000 and avalue of $22,000. A receives $11,000 in cash in liquidation of his entire interest in the partnership. He has a gain of $1,000 under section 731(a)(1). If the election under section 754 is in effect, the partnership basis for the property becomes $20,000 ($19,000 plus $1,000).

Example (2). Partner D has a basis of $10,000 for his one-third interest in partnership DEF. The partnership balance sheet before the distribution shows the following:

Assets	*Adjusted basis*	*Value*
Cash	$4,000	$4,000
Property X	11,000	11,000
Property Y	15,000	18,000
Totals	$30,000	$33,000
Liabilities and Capital		
Liabilities	0	0
Capital:		
D	$10,000	$11,000
E	10,000	11,000
F	10,000	11,000
Totals	$30,000	$33,000

In liquidation of his entire interest in the partnership, D received property X with a partnership basis of $11,000. D's basis for property X is $10,000 under section 732(b). Where the election under section 754 is in effect, the excess of $1,000 (the partnership basis before the distribution less D's basis for property X after distribution) is added to the basis of property Y. The basis of property Y becomes $16,000 ($15,000 plus $1,000). If the distribution is made to a transferee partner who elects under section 732(d), see § 1.734–2.

(2) *Decrease in basis.*—Where the election provided in section 754 is in effect and a distribution is made in liquidation of a partner's entire interest, the partnership shall decrease the adjusted basis of the remaining partnership property by—

(i) The amount of loss, if any, recognized under section 731(a)(2) to the distributee partner, or

(ii) The excess of the basis of the distributed property to the distributee, as determined under section 732 (including adjustments under section 743(b) or section 732(d) when applied) over the adjusted basis of such property to the partnership (including such special basis adjustments) immediately before such distribution.

The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner G has a basis of $11,000 for his one-third interest in partnership GHI. Partnership assets consist of cash of $10,000 and property with a basis of $23,000 and a value of $20,000. There are no partnership liabilities. In liquidation of his entire interest in the partnership, G receives $10,000 in cash. He has a loss of $1,000 under section 731(a)(2). If the election

under section 754 is in effect, the partnership basis for the property becomes $22,000 ($23,000 less $1,000).

Example (2). Partner J has a basis of $11,000 for his one-third interest in partnership JKL. The partnership balance sheet before the distribution shows the following:

Assets

	Adjusted basis	*Value*
Cash	$5,000	$5,000
Property X	10,000	10,000
Property Y	18,000	15,000
Total	$33,000	$30,000

Liabilities and Capital

Liabilities	0	0
Capital:		
J	$11,000	$10,000
K	11,000	10,000
L	11,000	10,000
Total	$33,000	$30,000

In liquidation of his entire interest in the partnership, J receives property X with a partnership basis of $10,000. J's basis for property X under section 732(b) is $11,000. Where the election under section 754 is in effect, the excess of $1,000 ($11,000 basis of property X to J, the distributee, less its $10,000 adjusted basis to the partnership immediately before the distribution) decreases the basis of property Y in the partnership. Thus, the basis of property Y becomes $17,000 ($18,000 less $1,000). If the distribution is made to a transferee partner who elects under section 732(d), see § 1.734–2.

(c) *Allocation of basis.*—For allocation among the partnership properties of basis adjustments under section 734(b) and paragraph (b) of this section, see section 755 and § 1.755–1.

(d) *Returns.*—A partnership which must adjust the bases of partnership properties under section 734 shall attach a statement to the partnership return for the year of the distribution setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

§ 1.734–2 Adjustment After Distribution to Transferee Partner.—(a) In the case of a distribution of property by the partnership to a partner who has obtained all or part of his partnership interest by transfer, the adjustments to basis provided in section 743(b) and section 732(d) shall be taken into account in applying the rules under section 734(b). For determining the adjusted basis of distributed property to the partnership immediately before the distribution where there has been a prior transfer of a partnership interest with respect to which the election provided in section 754 or section 732(d) is in effect, see §§ 1.732–1 and 1.732–2.

(b)(1) If a transferee partner, in liquidation of his entire partnership interest, receives a distribution of property (including money) with respect to which he has no special basis adjustment, in exchange for his interest in property with respect to which he has a special basis adjustment, and does not utilize his entire special basis adjustment in

determining the basis of the distributed property to him under section 732, the unused special basis adjustment of the distributee shall be applied as an adjustment to the partnership basis of the property retained by the partnership and as to which the distributee did not use his special basis adjustment. The provisions of this subparagraph may be illustrated by the following example:

Example. Upon the death of his father, partner S acquires by inheritance a half-interest in partnership ACS. Partners A and C each have a one-quarter interest. The assets of the partnership consist of $10,000 cash and land used in farming worth $10,000 with a basis of $1,000 to the partnership. Since the partnership had made the election under section 754 at the time of the transfer, partner S has a special basis adjustment of $4,500 under section 743(b) with respect to his undivided half-interest in the real estate. The basis of S's partnership interest, in accordance with section 742, is $10,000. S retires from the partnership and receives $10,000 in cash in exchange for his entire interest. Since S has received no part of the real estate, his special basis adjustment of $4,500 will be allocated to the real estate, the remaining partnership property, and will increase its basis to the partnership to $5,500.

(2) The provisions of this paragraph do not apply to the extent that certain distributions are treated as sales or exchanges under section 751(b) (relating to unrealized receivables and substantially appreciated inventory items). See section 751(b) and § 1.751–1(b).

§ 1.735 Statutory Provisions; Character of Gain or Loss on Disposition of Distributed Property.

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.

§ 1.735–1 Character of Gain or Loss on Disposition of Distributed Property.—(a) *Sale or exchange of distributed property.*—(1) *Unrealized receivables.*—Any gain realized or loss sustained by a partner on a sale or exchange or other disposition of unrealized receivables (as defined in section 751(c)) received by him in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset.

(2) *Inventory items.*—Any gain realized or loss sustained by a partner on a sale or exchange of inventory items (as defined in section 751(d)(2)) received in a distribution from a partnership shall

be considered gain or loss from the sale or exchange of property other than a capital asset if such inventory items are sold or exchanged within 5 years from the date of the distribution by the partnership. The character of any gain or loss from a sale or exchange by the distributee partner of such inventory items after 5 years from the date of distribution shall be determined as of the date of such sale or exchange by reference to the character of the assets in his hands at that date (inventory items, capital assets, property used in a trade or business, etc.).

(b) *Holding period for distributed property.*—A partner's holding period for property distributed to him by a partnership shall include the period such property was held by the partnership. The provisions of this paragraph do not apply for the purpose of determining the 5-year period described in section 735(a)(2) and paragraph (a)(2) of this section. If the property has been contributed to the partnership by a partner, then the period that the property was held by such partner shall also be included. See section 1223(2). For a partnership's holding period for contributed property, see § 1.723–1.

(c) *Effective date.*—Section 735(a) applies to any property distributed by a partnership to a partner after March 9, 1954. See section 771(b)(2) and § 1.771–1(b)(2). However, see section 771(c).

§ 1.736 Statutory Provisions; Payments to a Retiring Partner or a Deceased Partner's Successor in Interest.

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.

§ 1.736–1 Payments to a Retiring Partner or a Deceased Partner's Successor in Interest.—(a) *Payments considered as distributive share or guaranteed payment.*—(1)(i) Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's

entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

(ii) A partner retires when he ceases to be a partner under local law. However, for the purposes of subchapter K, a retired partner or a deceased partner's successor will be treated as a partner until his interest in the partnership has been completely liquidated.

(2) When payments (including assumption of liabilities treated as a distribution of money under section 752) are made to a withdrawing partner, that is, a retiring partner or the estate or other successor in interest of a deceased partner, the amounts paid may represent several items. In part, they may represent the fair market value at the time of his death or retirement of the withdrawing partner's interest in all the assets of the partnership (including inventory) unreduced by partnership liabilities. Also, part of such payments may be attributable to his interest in unrealized receivables and part to an arrangement among the partners in the nature of mutual insurance. When a partnership makes such payments, whether or not related to partnership income, to retire the withdrawing partner's entire interest in the partnership, the payments must be allocated between (i) payments for the value of his interest in assets, except unrealized receivables and, under some circumstances, good will (section 736(b)), and (ii) other payments (section 736(a)). The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under sections 731, 732, and, where applicable, 751. See § 1.751–1(b)(4)(ii). The remaining partners are allowed no deduction for these payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership (composed of the remaining partners).

(3) Under section 736(a), the portion of the payments made to a withdrawing partner for his share of unrealized receivables, good will (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in assets under the rules contained in paragraph (b) of this section will be considered either—

(i) A distributive share of partnership income, if the amount of payment is determined with regard to income of the partnership; or

(ii) A guaranteed payment under section 707(c), if the amount of the payment is determined without regard to income of the partnership.

(4) Payments, to the extent considered as a distributive share of partnership income under section 736(a)(1), are taken into account under section 702 in the income of the withdrawing partner and thus reduce the amount of the distributive shares of the remaining partners. Payments, to the extent considered as guaranteed payments under section 736(a)(2), are deductible by the partnership under section 162(a) and are taxable as ordinary income to the recipient under section 61(a). See section 707(c).

(5) The amount of any payments under section 736(a) shall be included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share, or in which the partnership is entitled to deduct such amount as a guaranteed payment. On the other hand, payments under section 736(b) shall be taken into account by the recipient for his taxable year in which such payments are made. See paragraph (b)(4) of this section.

(6) A retiring partner or a deceased partner's successor in interest receiving payments under section 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time. Similarly, if a partner in a 2-man partnership dies, and his estate or other successor in interest receives payments under section 736, the partnership shall not be considered to have terminated upon the death of the partner but shall terminate as to both partners only when the entire interest of the decedent is liquidated. See section 708(b).

(b) *Payments for interest in partnership.*—(1) Payments made in liquidation of the entire interest of a retiring partner or deceased partner shall, to the extent made in exchange for such partner's interest in partnership property (except for unrealized receivables and good will as provided in subparagraphs (2) and (3) of this paragraph), be considered as a distribution by the partnership (and not as a distributive share or guaranteed payment under section 736(a)). Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct. If such valuation reflects only the partner's net interest in the property (i. e., total assets less liabilities), it must be adjusted so that both the value of the partner's interest in property and the basis for his interest take into account the partner's share of partnership liabilities. Gain or loss with respect to distributions under section 736(b) and this paragraph will be recognized to the distributee to the extent provided in section 731 and, where applicable, section 751.

(2) Payments made to a retiring partner or to the successor in interest of a deceased partner for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, shall not be considered as made in exchange for such partner's interest in partnership property. Such payments shall be treated as payments under section 736(a) and paragraph (a) of this section. For definition of unrealized receivables, see section 751(c).

(3) For the purposes of section 736(b) and this paragraph, payments made to a retiring partner or to a successor in interest of a deceased partner in exchange for the interest of such partner in partnership property shall not include any amount paid for the partner's share of good will of the partnership in excess of its partnership basis, including any special basis adjustments for it to which

such partner is entitled, except to the extent that the partnership agreement provides for a reasonable payment with respect to such good will. Such payments shall be considered as payments under section 736(a). To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

(4) Payments made to a retiring partner or to a successor in interest of a deceased partner for his interest in inventory shall be considered as made in exchange for such partner's interest in partnership property for the purposes of section 736(b) and this paragraph. However, payments for an interest in substantially appreciated inventory items, as defined in section 751(d), are subject to the rules provided in section 751(b) and § 1.751–1(b). The partnership basis in inventory items as to a deceased partner's successor in interest does not change because of the death of the partner unless the partnership has elected the optional basis adjustment under section 754. But see § 1.751–1(b)(3)(iii).

(5) Where payments made under section 736 are received during the taxable year, the recipient must segregate that portion of each such payment which is determined to be in exchange for the partner's interest in partnership property and treated as a distribution under section 736(b) from that portion treated as a distributive share or guaranteed payment under section 736(a). Such allocation shall be made as follows—

(i) If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payment for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under section 736(a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a)(1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736(b) for that year, then any unapplied portion shall be added to the portion of the payments for the following year or years which are to be treated as a distribution under section 736(b). For example, retiring partner W who is entitled to an annual payment of $6,000 for 10 years for his interest in partnership property, receives only $3,500 in 1955. In 1956, he receives $10,000. Of this amount, $8,500 ($6,000 plus $2,500 from 1955) is treated as a distribution under section 736(b) for 1956; $1,500, as a payment under section 736(a).

(ii) If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a).

(iii) In lieu of the rules provided in subdivisions (i) and (ii) of this subparagraph, the allocation of each annual payment between section 736 (a) and (b) may be made in any manner to which all the remaining partners and the withdrawing partner or his successor in interest agree, provided that the total amount allocated to property under section 736(b) does not exceed the fair market value of such property at the date of death or retirement.

(6) Except to the extent section 751(b) applies, the amount of any gain or loss with respect to payments under section 736(b) for a retiring or deceased partner's interest in property for each year of payment shall be determined under section 731. However, where the total of section 736(b) payments is a fixed sum, a retiring partner or a deceased partner's successor in interest may elect (in his tax return for the first taxable year for which he receives such payments), to report and to measure the amount of any again or loss by the difference between—

(i) The amount treated as a distribution under section 736(b) in that year, and

(ii) The portion of the adjusted basis of the partner for his partnership interest attributable to such distribution (i e., the amount which bears the same proportion to the partner's total adjusted basis for his partnership interest as the amount distributed under section 736(b) in that year bears to the total amount to be distributed under section 736(b)).

A recipient who elects under this subparagraph shall attach a statement to his tax return for the first taxable year for which he receives such payments, indicating his election and showing the computation of the gain included in gross income.

(7) The provisions of this paragraph may be illustrated by the following examples:

Example (1). Partnership ABC is a personal service partnership and its balance sheet is as follows:

Assets			Liabilities and capital		
	Adjusted basis per books	Market value		Per books	Value
Cash	$13,000	$13,000	Liabilities	$3,000	$3,000
Unrealized receivables	0	30,000	Capital:		
Capital and section 1231 assets	20,000	23,000	A	10,000	21,000
			B	10,000	21,000
Total	$33,000	$66,000	C	10,000	21,000
			Total	$33,000	$66,000

Partner A retires from the partnership in accordance with an agreement whereby his share of liabilities ($1,000) is assumed. In addition he is to receive $9,000 in the year of retirement plus $10,000 in each of the two succeeding years. Thus, the total that A receives for his partnership interest is $30,000 ($29,000 in cash and $1,000 in liabilities assumed). Under the agreement terminating A's interest, the value of A's interest in section 736(b) partnership property is $12,000 (one-third of $36,000, the sum of $13,000 cash and $23,000, the fair market value of capital and section 1231

assets). A's share in unrealized receivables is not included in his interest in partnership property described in section 736(b). Since the basis of A's interest is $11,000 ($10,000 plus $1,000, his share of partnership liabilities), he will realize a capital gain of $1,000 ($12,000 minus $11,000) from the disposition of his interest in partnership property. The remaining $18,000 ($30,000 minus $12,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c). The payment for the first year is $10,000, consisting of $9,000 in cash, plus $1,000 in liability assumed (section 752(b)). Thus, unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, each annual payment of $10,000 will be allocated as follows: $6,000 (18,000/30,000 of $10,000) is a section 736(a)(2) payment and $4,000 (12,000/30,000 of $10,000) is a payment for an interest in section 736(b) partnership property. (The partnership may deduct the $6,000 guaranteed payment made to A in each of the 3 years.) The gain on the payments for partnership property will be determined under section 731, as provided in subparagraph (6) of this paragraph. A will treat only $4,000 of each payment as a distribution in a series in liquidation of his entire interest and, under section 731, will have a capital gain of $1,000 when the last payment is made. However, if A so elects, as provided in subparagraph (6) of this paragraph, he may treat such gain as follows: Of each $4,000 payment attributable to A's interest in partnership property, $333 is capital gain (one-third of the total capital gain of $1,000), and $3,667 is a return of capital.

Example (2). Assume the same facts as in example (1) of this subparagraph except that the agreement between the partners provides for payments to A for 3 years of a percentage of annual income instead of a fixed amount. Unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, all payments received by A up to $12,000 shall be treated under section 736(b) as payments for A's interest in partnership property. His gain of $1,000 will be taxed only after he has received his full basis under section 731. Since the payments are not fixed in amount, the election provided in subparagraph (6) of this paragraph is not available. Any payments in excess of $12,000 shall be treated as a distributive share of partnership income to A under section 736(a)(1).

Example (3). Assume the same facts as in example (1) of this subparagraph except that the partnership agreement provides that the payment for A's interest in partnership property shall include payment for his interest in the good will of the partnership. At the time of A's retirement, the partners determine the value of partnership good will to be $9,000. The value of A's interest in partnership property described in section 736(b) is thus $15,000 (one-third of $45,000, the sum of $13,000 cash, plus $23,000, the value of capital and section 1231 assets, plus $9,000 goodwill). From the disposition of his interest in partnership property, A will realize a capital gain of $4,000 ($15,000, minus $11,000, the basis of his interest. The remaining $15,000 ($30,000 minus $15,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

(c) *Cross reference.*—See section 753 for treatment of payments under section 736(a) as income in respect of a decedent under section 691.

Transfers of Interests in a Partnership

§ 1.741 STATUTORY PROVISIONS; RECOGNITION AND CHARACTER OF GAIN OR LOSS ON SALE OR EXCHANGE.

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).

§ 1.741–1 RECOGNITION AND CHARACTER OF GAIN OR LOSS ON SALE OR EXCHANGE.—(a) The sale or exchange of an interest in a partnership shall, except to the extent section 751(a) applies, be treated as the sale or exchange of a capital asset, resulting in capital gain or loss measured by the difference between the amount realized and the adjusted basis of the partnership interest, as determined under section 705. For treatment of selling partner's distributive share up to date of sale, see section 706(c)(2). Where the provisions of section 751 require the recognition of ordinary income or loss with respect to a portion of the amount realized from such sale or exchange, the amount realized shall be reduced by the amount attributable under section 751 to unrealized receivables and substantially appreciated inventory items, and the adjusted basis of the transferor partner's interest in the partnership shall be reduced by the portion of such basis attributable to such unrealized receivables and substantially appreciated inventory items. See section 751 and § 1.751–1.

(b) Section 741 shall apply whether the partnership interest is sold to one or more members of the partnership or to one or more persons who are not members of the partnership. Section 741 shall also apply even though the sale of the partnership interest results in a termination of the partnership under section 708(b). Thus, the provisions of section 741 shall be applicable (1) to the transferor partner in a 2-man partnership when he sells his interest to the other partner, and (2) to all the members of a partnership when they sell their interests to one or more persons outside the partnership.

(c) See section 351 for nonrecognition of gain or loss upon transfer of a partnership interest to a corporation controlled by the transferor.

§ 1.742 STATUTORY PROVISIONS; BASIS OF TRANSFEREE PARTNER'S INTEREST.

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 0 (Section 1011 and following).

§ 1.742–1 BASIS OF TRANSFEREE PARTNER'S INTEREST.—The basis to a transferee partner of an interest in a partnership shall be determined under the general basis rules for property provided by part II of subchapter 0 (sections 1011 to 1022, inclusive). Thus, the basis of a purchased interest will be its cost. The basis of a partnership interest acquired from a decedent is the fair market value of the interest at

the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and §§ 1.706–1(c)(3)(v) and 1.753–1(b)) under section 691. See section 1014(c). For basis of contributing partner's interest, see section 722. The basis so determined is then subject to the adjustments provided in section 705.

§ 1.743 STATUTORY PROVISIONS; OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.

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.

§ 1.743–1 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, either by sale or exchange or as a result of 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 the partnership. However, whether or not the election provided in section 754 is in effect, the basis of partnership property shall not be adjusted as the result of a contribution of property, including money, to the partnership.

(b) *Adjustment to basis of partnership property.*—(1) *Determination of adjustment.*—In the case of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership as to which the election under section 754 is in effect shall—

(i) Increase the adjusted basis of partnership property by the excess of the transferee's basis for his partnership interest over his share of the adjusted basis to the partnership of all partnership property, or

(ii) Decrease the adjusted basis of partnership property by the excess of the transferee partner's share of the adjusted basis of all partnership property over his basis for his partnership interest.

The amount of the increase or decrease constitutes an adjustment affecting the basis of partnership property with respect to the transferee partner only. Thus, for purposes of depreciation, depletion, gain or loss, and distributions, the transferee partner will have a special basis for those partnership properties which are adjusted under section 743(b) and this paragraph. This special basis is his share of the common partnership basis (i. e., the adjusted basis of such properties to the partnership without regard to any special basis adjustments of any transferee) plus or minus his special basis adjustments. A partner's share of the adjusted basis of partnership property is equal to the sum of his interest as a partner in partnership capital and surplus, plus his share of partnership liabilities. Where an agreement with respect to contributed property is in effect under section 704(c)(2), such agreement shall be taken into account in determining a partner's share of the adjusted basis of partnership property. Generally, if a partner's interest in partnership capital and profits is ⅓, his share of the adjusted basis of partnership property will be ⅓ of such basis. The provisions of this paragraph may be illustrated by the following examples:

Example (1). A is a member of partnership ABC in which the partners have equal interests in capital and profits. The partnership has made the election under section 754, relating to the optional adjustment to the basis of partnership property. A sells his interest to P for $22,000. The balance sheet of the partnership at the date of sale shows the following:

Assets			Liabilities and capital		
	Adjusted basis per books	Market value		Adjusted basis per books	Value
Cash	$5,000	$5,000	Liabilities	$10,000	$10,000
Accounts receivable	10,000	10,000	Capital:		
Inventory	20,000	21,000	A	15,000	22,000
Depreciable assets	20,000	40,000	B	15,000	22,000
			C	15,000	22,000
Total	$55,000	$76,000	Total	$55,000	$76,000

The amount of the adjustment under section 743(b) is the difference between the basis of the transferee's interest in the partnership and his share of the adjusted basis of partnership property. Under section 742, the basis of P's interest is $25,333 (the cash paid for A's interest, $22,000, plus $3,333, P's share of partnership liabilities). P's share of the adjusted basis of partnership property is $18,333, i. e., $15,000 plus $3,333. The amount to be added to the basis of partnership property is, therefore,

$7,000, the difference between $25,333 and $18,333. This amount will be allocated to partnership properties in accordance with the rules set forth in section 755 and § 1.755–1.

Example (2). D is a member of partnership DEF in which the partners have equal interests in profits, but not in capital. The partnership has made the election under section 754. D dies and his interest passes to W, his widow. The balance sheet of the partnership at the date of D's death shows the following:

Assets			Liabilities and capital		
	Adjusted basis per books	Market value		Adjusted basis per books	Value
Cash	$7,000	$7,000	Liabilities	$10,000	$10,000
Accounts receivable	10,000	10,000	Capital:		
Inventory	20,000	24,000	D	18,000	26,000
Depreciable assets	20,000	40,000	E	15,000	23,000
			F	14,000	22,000
Total	$57,000	$81,000	Total	$57,000	$81,000

The amount of the adjustment under section 743(b) is the difference between the basis of the transferee's interest in the partnership and her share of the adjusted basis of partnership property. Under section 742, the basis of W's interest is $29,333 (the fair market value of D's interest at his death, $26,000, plus $3,333, his share of partnership liabilities). W's share of the adjusted basis of partnership property is $21,333 (i. e., $18,000 plus $3,333, her share of partnership liabilities). The amount to be added to the basis of partnership property is, therefore, $8,000, the difference between $29,333 and $21,333. This amount will be allocated to partnership properties in accordance with the rules set forth in section 755 and § 1.755–1.

Note that in examples (1) and (2) of this subparagraph the amount of the adjustment does not depend upon the adjusted basis to the transfereor for his interest in partnership capital.

(2) *Determination of partner's share of adjusted basis of partnership property.*—(i) Under the provisions of section 743(b), a partner's share of the adjusted basis of partnership property shall be determined by taking into acccount the effect of any partnership agreement with respect to contributed property as described in section 704(c)(2), or the effect of the contribution of undivided interests under section 704(c)(3). This rule may be illustrated by the following examples:

Example (1). A, B, and C form partnership ABC, to which A contributes land worth $1,000 (property X) with an adjusted basis to him of $400, and B and C each contributes $1,000 cash. Each partner has $1,000 credited to him on the books of the partnership as his capital contribution. The partners share in profits equally. During the partnership's first taxable year, property X appreciates in value to $1,300. A sells his one-third interest in the partnership to D for $1,100, when the election under section 754 is in effect. No agreement under section 704(c)(2) is in effect. The adjusted basis of the partnership property is in-

creased with respect to D by the excess of his basis for his partnership interest, $1,100, over his share of the adjusted basis of partnership property, $800 (⅓ of $2,400, the total adjusted basis of partnership property). The amount of the adjustment, therefore, is $300 ($1,100 minus $800), which is an increase in the basis of partnership property with respect to D only. This special basis adjustment will be allocated to property X. (See section 755 and § 1.755–1.) If property X is sold for $1,600, the gain to the partnership is $1,200 ($1,600 received, less the adjusted common partnership basis of $400 for property X). Thus, each partner's distributive share of the gain on the sale is $400. However, D's recognized gain is only $100 (his $400 distributive share of the gain, reduced by $300, his special basis adjustment with respect to property X). If D purchased his interest from B or C, the partners who contributed cash, D's adjustment under section 743(b) would also be $300, computed in exactly the same manner as in the case of a purchase from A.

Example (2). Assume that partnership ABC described in example (1) of this subdivision has an agreement under section 704(c)(2) withrespect to property X, stating that upon the sale of that property any gain, to the extent attributable to the precontribution appreciation of $600 (the difference between its value, $1,000, and its basis, $400, at the time of the contribution) is to be allocated entirely to A, who contributed property X. Upon the purchase of A's interest by D for $1,100, the computation of D's special basis would differ from that indicated in example (1) of this subdivision as follows: Under the partnership agreement, A's share of the $2,400 adjusted basis of partnership property is only $400 (his basis for property X prior to its contribution to the partnership), and B's and C's share is $1,000 each (the amount of the cash investment of each). The amount of the increase to D in the adjusted basis of partnership property under section 743(b)(1) is $700 (the excess of $1,000, D's cost basis for his interest, over $400, A's share of the adjusted basis of partnership property to which D succeeds). This amount constitutes an adjustment to the basis of partnership property with respect to D only. If X is sold by the partnership for $1,600, the gain is $1,200 ($1,600 received less the adjusted common partnership basis of $400). Under the partnership agreement, $600 of this gain, which is attributable to precontribution appreciation in value, is allocable to D, who is A's successor. The remaining $600 gain is not subject to the agreement and is allocable to the partners equally, $200 each. D's distributive share of the partnership gain is thus $600 plus $200, or $800. However, D has a special basis adjustment of $700 under section 743(b)(1), which reduces his gain from $800 to $100. B and C each has a gain of $200, which is unaffected by the transfer of A's interest to D.

Example (3). Assume the same facts as in example (2) of this subdivision, except that D has purchased his interest from B instead of from A. His special basis adjustment for partnership property in this case differs from that where he had purchased his interest from A, because of the effect of the agreement under section 704(c)(2). In this case, D is a successor to B, whose

share of the adjusted basis of partnership property is $1,000, instead of A, whose share is only $400. As a result, the adjustment under section 743(b)(1) is the excess of D's cost basis for his interest, $1,100, over his share of the adjusted basis of partnership property, $1,000, or $100. In this case, if property X is sold for $1,600, the partnership gain is $1,200 ($1,600 less the adjusted partnership basis of $400). Of this gain, $600, representing precontribution appreciation, is allocable to A under the partnership agreement. The remaining $600 is allocable in the amount of $200 to each partner. Since D as a transferee has a special basis adjustment of $100 under section 743(b)(1), his gain is reduced from $200 to $100.

(ii) If a partner receives a distribution of property with respect to which another partner has a special basis adjustment, the distributee shall not take into account the special basis adjustment of the other partner. However, the partner with the special basis adjustment will reallocate it under section 755 to remaining partnership property of a like kind or, if he receives a distribution of like property, to such distributed property. If a partner receives a distribution of property with respect to which he has a special basis adjustment, such basis adjustment will be taken into account when relevant under section 732. See § 1.732–2(b). If, at the time a partner receives property (whether or not he has a special basis adjustment with respect to such property), he relinquishes his interest in other property of a like kind with respect to which he has a special basis adjustment, the adjusted basis to the partnership of the distributed property shall include his special basis adjustment for the property in which he relinquished his interest. For the purposes of the preceding sentence, a partner will be considered as having relinquished his interest in any remaining partnership properties when his interest has been completely liquidated; however, when a partner receives a distribution not in liquidation, he will be considered as relinquishing his interest only in property distributed to other partners. For the purposes of this subdivision, like property means property of the same class, that is, stock in trade, property used in the trade or business, capital assets, etc. For certain adjustments to the basis of remaining partnership property after a distribution to a transferee partner, see § 1.734–2(b). The provisions of this subdivision may be illustrated by the following examples:

Example (1). C is a transferee partner in partnership BC. The partnership owns, among other assets, X, a depreciable asset with a common basis to the partnership of $1,000 and a special basis adjustment to C of $200, and Y, another depreciable asset with a common basis of $800 and a special basis adjustment to C of $300. B and C agree that B will receive a distribution of property Y, and C will receive a distribution of property X, with all other property to remain in the partnership. With respect to B, the partnership basis of property Y is $800, the common partnership basis. Y will, therefore, have a basis of $800 in B's hands under section 732(a) which provides for the use of a carryover basis in the case of current distributions. With respect to C, however, the partnership basis of property X is $1,500, the common partnership basis of $1,000, plus C's special basis adjustment of $200 for property X, plus C's additional special basis adjust-

ment of $300 for property Y, in which he has relinquished his interest.

Example (2). (a) Partner D acquired his one-third interest in partnership BCD for $14,000 from a previous partner when an election under section 754 was in effect. Therefore, under section 743(b), D has a special basis adjustment for certain partnership property. Assume that at the time of the distribution in paragraph (b) of this example, the partnership assets consist of cash and rental property and that such assets and D's special basis adjustments under section 743(b) are as follows:

Item	Fair market value	Common partnership basis	D's share	D's special basis adjustment	Partnership basis to D
Cash	$12,000	$12,000	$4,000		$4,000
House:					
U	9,000	1,200	400		400
V	6,000	4,500	1,500		1,500
W	8,000	1,500	500		500
X	9,000	4,800	1,600	$2,000	3,600
Y	9,000	6,000	2,000		2,000
Z	7,000	3,000	1,000	1,000	2,000
Totals	$60,000	$33,000	$11,000	$3,000	$14,000

(b) Assume further that D receives $4,000 in cash and houses Y and Z in complete liquidation of his interest in partnership BCD. In determining the basis to D of houses Y and Z under section 732 (b) and (c), D must allocate $10,000 basis ($14,000 basis for his interest, less $4,000 cash received) to houses Y and Z in proportion to their adjusted bases to the partnership. For purposes of section 732(c), the adjusted basis of house Y is $7,200. ($6,000 common partnership basis, plus $1,200, allocated share of D's special basis adjustment of $2,000 for house X, in which D relinquished his interest). The adjusted basis of house Z is $4,800 ($3,000 common partnership basis, plus $1,000, D's special basis for house Z, plus $800, allocated share of D's special basis of $2,000 for house X, in which D relinquished his interest). See subparagraph (2)(ii) of this paragraph under which 6,000/10,000 of the $2,000 special basis adjustment for X is allocated to Y and 4,000/10,000 of such amount to Z. Therefore, $6,000 basis (7,200/12,000 of $10,000) is allocated to house Y and $4,000 basis (4,800/12,000 of $10,000) to house Z.

(c) Since houses Y and Z had $12,000 basis to the partnership, as computed in paragraph (b) of this example, and only $10,000 basis to D, as determined under section 732, the partnership, under section 734(b)(1)(B), must increase the basis of remaining partnership property (houses U, V, W, and X) by $2,000 (excess of $12,000 over $10,000). For allocation of this amount, see section 755 and § 1.755–1.

(iii) Where an adjustment is made under section 743(b) to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for each partner, including the transferee partner, based on his interest in such property. See § 1.702–1(a)(8). This rule may be illustrated by the following example:

Example. A, B, and C each contributes $5,000 cash to form partnership ABC, which purchases oil property for $15,000. C

subsequently sells his partnership interest to D for $100,000 when the election under section 754 is in effect. D has a special basis adjustment for the oil property of $95,000 (the difference between D's basis, $100,000, and his share of the basis of partnership property, $5,000). Assume that the depletion allowance computed under the percentage method would be $21,000 for the taxable year so that each partner would be entitled to $7,000 as his share of the deduction for depletion. However, under the cost depletion method, at an assumed rate of 10 percent, the allowance with respect to D's one-third interest which has a basis to him of $100,000 ($5,000, plus his special basis adjustment of $95,000) is $10,000, although the cost depletion allowance with respect to the one-third interest of A and B in the oil property, each of which has a basis of $5,000, is only $500. For partners A and B, the percentage depletion is greater than cost depletion and each will deduct $7,000 based on the percentage depletion method. However, as to D, the transferee partner, the cost depletion method results in a greater allowance and D will, therefore, deduct $10,000 based on cost depletion. See section 613(a).

(iv) Where there has been more than one transfer of partnership interests, the last transferee's special basis adjustment, if any, under section 743(b) shall be determined by reference to the partnership common basis for its property without regard to any prior transferee's special basis adjustment. For example, A, B, and C form a partnership. A and B each contributes $1,000 cash and C contributes land with a basis and value of $1,000. When the land has appreciated in value to $1,300, A sells his interest to D for $1,100 (⅓ of $3,300, the value of the partnership property). The election under section 754 is in effect; therefore, D has a special basis adjustment of $100 with respect to the land under section 743(b). After the land has further appreciated in value to $1,600, D sells his interest to E for $1,200 (⅓ of $3,600, the value of the partnership property). Under section 743(b), E has a special basis adjustment of $200. This amount is determined without regard to any special basis adjustment that D may have had in the partnership assets.

(3) *Returns.*—A transferee partner who has a special basis adjustment under section 743(b) shall attach a statement to his income tax return for the first taxable year in which the basis of any partnership property subject to the adjustment is pertinent in determining his income tax, showing the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(c) *Allocation of basis.*—For the allocation of basis among partnership properties where section 743(b) applies, see section 755 and § 1.755–1.

Provisions Common to Other Subparts

§ 1.751 Statutory Provisions; Unrealized Receivables and Inventory Items.

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).

§ 1.751-1 UNREALIZED RECEIVABLES AND INVENTORY ITEMS.—(a) *Sale or exchange of interest in a partnership.*—(1) *Character of amount realized.*—To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. For definition of "unrealized receivables" and "inventory items which have appreciated

substantially in value", see section 751 (c) and (d). Unrealized receivables and substantially appreciated inventory items are hereafter in this section referred to as "section 751 property". See paragraph (e) of this section.

(2) *Determination of gain or loss.*—The income or loss realized by a partner upon the sale or exchange of his interest in section 751 property is the difference between (i) the portion of the total amount realized for the partnership interest allocated to section 751 property, and (ii) the portion of the selling partner's basis for his entire interest allocated to such property. Generally, the portion of the total amount realized which the seller and the purchaser allocate to section 751 property in an arm's length agreement will be regarded as correct. The portion of the partner's adjusted basis for his partnership interest to be allocated to section 751 property shall be an amount equal to the basis such property would have had under section 732 (including subsection (d) thereof) if the selling partner had received his share of such properties in a current distribution made immediately before the sale. See §§ 1.732–1 and 1.732–2. Such basis shall reflect the rules of section 704(c)(3), if applicable, or any agreement under section 704(c)(2). Any gain or loss recognized which is attributable to section 751 property will be ordinary gain or loss. The difference between the remainder, if any, of the partner's adjusted basis for his partnership interest and the balance, if any, of the amount realized is the transferor's capital gain or loss on the sale of his partnership interest.

(3) *Statement required.*—A transferor partner selling or exchanging any part of his interest in a partnership which has any section 751 property at the time of sale or exchange shall submit with his income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information:

(i) The date of the sale or exchange, the amount of the transferor partner's adjusted basis for his partnership interest, and the portion thereof attributable to section 751 property under section 732; and

(ii) The amount of any money and the fair market value of any other property received or to be received for the transferred interest in the partnership, and the portion thereof attributable to section 751 property.

(iii) If the transferor partner computes his adjusted basis for section 751 property under the provisions of section 732(d), he must also include in the statement the information required by § 1.732–1(d)(3).

(iv) If the transferor partner has a special basis adjustment under section 743(b), he must also include in the statement the computation of his special basis adjustment and the partnership properties to which the adjustment has been allocated.

(b) *Certain distributions treated as sales or exchanges.*—(1) *In general.*—(i) Certain distributions to which section 751(b) applies are treated in part as sales or exchanges of property between the partnership and the distributee partner, and not as distributions to which sections 731 through 736 apply. A distribution treated as a sale or exchange under section 751(b) is not subject to the provisions of section 707(b). Section 751(b) applies whether or not the distribution

is in liquidation of the distributee partner's entire interest in the partnership. However, section 751(b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property.

(ii) Section 751(b) does not apply to a distribution to a partner which is not in exchange for his interest in other partnership property. Thus, section 751(b) does not apply to the extent that a distribution consists of the distributee partner's share of section 751 property or his share of other property. Similarly, section 751(b) does not apply to current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital. In determining whether a partner has received only his share of either section 751 property or of other property, his interest in such property remaining in the partnership immediately after a distribution must be taken into account. For example, the section 751 property in partnership ABC has a fair market value of $100,000 in which partner A has an interest of 30 percent, or $30,000. If A receives $20,000 of section 751 property in a distribution, and continues to have a 30-percent interest in the $80,000 of section 751 property remaining in the partnership after the distribution, only $6,000 ($30,000 minus $24,000 (30 percent of $80,000)) of the section 751 property received by him will be considered to be his share of such property. The remaining $14,000 ($20,000 minus $6,000) received is in excess of his share.

(iii) If a distribution is, in part, a distribution of the distributee partner's share of section 751 property, or of other property (including money) and, in part, a distribution in exchange of such properties, the distribution shall be divided for the purpose of applying section 751(b). The rules of section 751(b) shall first apply to the part of the distribution treated as a sale or exchange of such properties, and then the rules of sections 731 through 736 shall apply to the part of the distribution not treated as a sale or exchange. See paragraph (b)(4)(ii) of this section for treatment of payments under section 736(a).

(2) *Distribution of section 751 property (unrealized receivables or substantially appreciated inventory items).*—(i) To the extent that a partner receives section 751 property in a distribution in exchange for any part of his interest in partnership property (including money) other than section 751 property, the transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the income or loss to the partnership will be measured by the difference between the adjusted basis to the partnership of the section 751 property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in other partnership property which he relinquished in the exchange. In computing the partners' distributive shares of such ordinary income or loss, the income

or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes gain or loss measured by the difference between his adjusted basis for the property relinquished in the exchange (including any special basis adjustment which he may have) and the fair market value of the section 751 property received by him in exchange for his interest in other property which he has relinquished. The distributee's adjusted basis for the property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b). The character of the gain or loss to the distributee partner shall be determined by the character of the property in which he relinquished his interest.

(3) *Distribution of partnership property other than section 751 property.*—(i) To the extent that a partner receives a distribution of partnership property (including money) other than section 751 property in exchange for any part of his interest in section 751 property of the partnership, the distribution shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes gain or loss on the sale or exchange of the property other than section 751 property. The amount of the gain to the partnership will be measured by the difference between the adjusted basis to the partnership of the distributed property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in section 751 property which he relinquished in the exchange. The character of the gain or loss to the partnership is determined by the character of the distributed property treated as sold or exchanged by the partnership. In computing the partners' distributive shares of such gain or loss, the gain or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the distributee partner's income or loss shall be measured by the difference between his adjusted basis for the section 751 property relinquished in the exchange (including any special basis adjustment which he may have), and the fair market value of other property (including money) received by him in exchange for his interest in the section 751 property which he has relinquished. The distributee partner's adjusted basis for the section 751 property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b).

(4) *Exceptions.*—(i) Section 751(b) does not apply to the distribution to a partner of property which the distributee partner con-

tributed to the partnership. The distribution of such property is governed by the rules set forth in section 731 through 736, relating to distributions by a partnership.

(ii) Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and § 1.736–1.

(5) *Statement required.*—A partnership which distributes section 751 property to a partner in exchange for his interest in other partnership property, or which distributes other property in exchange for any part of the partner's interest in section 751 property, shall submit with its return for the year of the distribution a statement showing the computation of any income, gain, or loss to the partnership under the provisions of section 751(b) and this paragraph. The distributee partner shall submit with his return a statement showing the computation of any income, gain, or loss to him. Such statement shall contain information similar to that required under paragraph (a)(3) of this section.

(c) *Unrealized receivables.*—(1) The term "unrealized receivables", as used in subchapter K, means any rights (contractual or otherwise) to payment for—

(i) Goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or

(ii) Services rendered or to be rendered,

to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

(2) The basis for such unrealized receivables shall include all costs or expenses attributable thereto paid or accrued but not previ-

ously taken into account under the partnership method of accounting.

(3) In determining the amount of the sale price attributable to unrealized receivables, or their value in a distribution treated as a sale or exchange, any arm's length agreement between the buyer and the seller, or between the partnership and the distributee partner, will generally establish the amount or value. In the absence of such an agreement, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

(d) *Inventory items which have substantially appreciated in value.*—(1) *Substantial appreciation.*—Partnership inventory items shall be considered to have appreciated substantially in value if, at the time of the sale or distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of the aggregate adjusted basis for such property in the hands of the partnership (without regard to any special basis adjustment of any partner) and, in addition, exceeds 10 percent of the fair market value of all partnership property other than money. The terms "inventory items which have appreciated substantially in value" or "substantially appreciated inventory items" refer to the aggregate of all partnership inventory items. These terms do not refer to specific partnership inventory items or to specific groups of such items. For example, any distribution of inventory items by a partnership the inventory items of which as a whole are substantially appreciated in value shall be a distribution of substantially appreciated inventory items for the purposes of section 751(b), even though the specific inventory items distributed may not be appreciated in value. Similarly, if the aggregate of partnership inventory items are not substantially appreciated in value, a distribution of specific inventory items, the value of which is more than 120 percent of their adjusted basis, will not constitute a distribution of substantially appreciated inventory items. For the purpose of this paragraph, the "fair market value" of inventory items has the same meaning as "market" value in the regulations under section 471, relating to general rule for inventories.

(2) *Inventory items.*—The term "inventory items" as used in subchapter K includes the following types of property:

(i) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the taxable year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business. See section 1221(1).

(ii) 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. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items (see section 1221(4)), as do any unrealized receivables.

(iii) Any other property retained by the partnership which, if held by the partner selling his partnership interest or receiving a distribution described in section 751(b), would be considered property described in subdivisions (i) or (ii) of this subpara-

graph. Property actually distributed to the partner does not come within the provisions of section 751(d)(2)(C) and this subdivision.

(e) *Section 751 property and other property.*—For the purposes of this section, "section 751 property" means unrealized receivables or substantially appreciated inventory items, and "other property" means all property (including money) except section 751 property.

(f) *Effective date.*—Section 751 applies 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, a partnership or a partner may elect to treat as applicable any other section of subchapter K. Any such election shall be made by a statement submitted not later than the time prescribed by law for the filing of the return for such taxable year, or submitted within 90 days after the promulgation of the regulations under this section, whichever date is later (but not later than 6 months after the time prescribed by law for the filing of the return for such year). See section 771(b)(3) and § 1.771–1(b)(3). See also section 771(c) and § 1.771–1(c).

(g) *Examples.* Application of the provisions of section 751 may be illustrated by the following examples:

Example (1). C buys B's interest in personal services partnership AB for $15,000, when the balance sheet of the firm (reflecting a cash receipts and disbursements method of accounting) is as follows:

Assets			Liabilities and capital		
	Adjusted basis per books	Market value		Per books	Value
Cash	$3,000	$3,000	Liabilities	$2,000	$2,000
Loans receivable	10,000	10,000	Capital:		
Other assets	7,000	7,000	A	9,000	15,000
Unrealized receivables	0	12,000	B	9,000	15,000
Total	$20,000	$32,000	Total	$20,000	$32,000

Section 751(a) applies to the sale. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B's share of the partnership liabilities assumed by C. See section 752. B's undivided half interest in the partnership property includes a half-interest in the partnership's unrealized receivables which are worth $12,000. Consequently, $6,000 of the $16,000 realized by B shall be considered received in exchange for B's interest in the partnership attributable to its unrealized receivables. The remaining $10,000 realized by B is in exchange for a capital asset. B's basis for his partnership interest is $10,000 ($9,000, plus $1,000, B's share of partnership liabilities). No portion of this basis is attributable to B's share of the unrealized receivables of the partnership since such property has a zero basis in the hands of the partnership; therefore, B has a basis of zero for the unrealized receivables because the partnership basis for

such receivables would have carried over to him under section 732 had they been distributed to him. The difference between the zero basis and the $6,000 B realized for the unrealized receivables is ordinary income to him. The entire $10,000 of B's basis is the basis for his interest in partnership property other than unrealized receivables and is applied against the remaining $10,000 ($16,000 minus $6,000) received from the sale of his interest. Therefore, B has no capital gain or loss. (If B's basis for his interest in partnership property, other than unrealized receivables, were $9,000, he would realize capital gain of $1,000. If his basis were $11,000, he would sustain a capital loss of $1,000.)

Example (2). (a) *Facts.*—Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

Assets			Liabilities and capital		
	Adjusted basis per books	Market value		Per books	Value
Cash	$15,000	$15,000	Current liabilities	$15,000	$15,000
Accounts receivable	9,000	9,000	Mortgage payable	21,000	21,000
Inventory	21,000	30,000	Capital:		
Depreciable property	42,000	48,000	A	20,000	25,000
Land	9,000	9,000	B	20,000	25,000
			C	20,000	25,000
Total	$96,000	$111,000	Total	$96,000	$111,000

The distribution received by C consists of $10,000 cash and depreciable property with a fair market value of $15,000 and an adjusted basis to the partnership of $15,000.

(b) *Presence of section 751 property.*—The partnership has no unrealized receivables, but the dual test provided in section 751(d)(1) must be applied to determine whether the inventory items of the partnership, in the aggregate, have appreciated substantially in value. The fair market value of all partnership inventory items, $39,000 (inventory $30,000, and accounts receivable $9,000), exceeds 120 percent of the $30,000 adjusted basis of such items to the partnership. The fair market value of the inventory items, $39,000, also exceeds 10 percent fo the fair market value of all partnership property other than money (10 percent of $96,000 or $9,600). Therefore, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.*—Since C's entire partnership interest is to be liquidated, the provisions of section 736 are applicable. No part of the payment, however, is considered as a distributive share or as a guaranteed payment under section 736(a) because the entire payment is made for C's interest in partnership property. Therefore, the entire payment is for an interest in partnership property under section 736(b), and, to the extent applicable, subject to the rules of section 751. In the distribution, C received his share of cash ($5,000) and $15,000

in depreciable property ($1,000 less than his $16,000 share). In addition, he received other partnership property ($5,000 cash and $12,000 liabilities assumed, treated as money distributed under section 752(b)) in exchange for his interest in accounts receivable ($3,000), inventory ($10,000), land ($3,000), and the balance of his interest in depreciable property ($1,000). Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i. e., inventory items, which include trade accounts receivable). The section 751 property exchanged has a fair market value of $13,000 ($3,000 in accounts receivable and $10,000 in inventory). Thus, $13,000 of the total amount C received is considered as received for the sale of section 751 property.

(d) *Distributee partner's tax consequences.*—C's tax consequences on the distribution are as follows:

(1) *The section* 751(b) *sale or exchange.*—C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is $10,000 ($7,000 for inventory and $3,000 for accounts receivable) as determined under paragraph (b)(3)(iii) of this section. Then C is considered as having sold his share of inventory items to the partnership for $13,000. Thus, on the sale of his share of inventory items, C realizes $3,000 of ordinary income.

(2) *The part of the distribution not under section* 751(b).—Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $10,000, the basis attributed to the section 751 property treated as distributed to C and sold by him to the partnership. Thus, C has a basis of $22,000 for the remainder of his partnership interest. The total distribution to C was $37,000 ($22,000 in cash and liabilities assumed, and $15,000 in depreciable property). Since C received no more than his share of the depreciable property, none of the depreciable property constituted proceeds of the sale under section 751(b). C did receive more than his share of money. Therefore, the sale proceeds, treated separately in subparagraph (1) of this paragraph of this example, must consist of mony and therefore must be deducted from the money distribution. Consequently, in liquidation of the balance of C's interest, he receives depreciable property and $9,000 in money ($22,000 less $13,000). Therefore, no gain or loss is recognized to C on the distribution. Under section 732 (b), C's basis for the depreciable property is $13,000 (the remaining basis of his partnership interest, $22,000, reduced by $9,000, the money received in the distribution).

(e) *Partnership's tax consequences.*—The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751*(b) *sale or exchange.*—The partnership consisting of the remaining members has no ordinary income on the distribution since it did not give up any section 751 property in the exchange. Of the $22,000 money distributed (in cash and the assumption of C's share of liabilities), $13,000 was paid to acquire C's interest in inventory ($10,000 fair market value) and

in accounts receivable ($3,000). Since under section 751(b) the partnership is treated as buying these properties, it has a new cost basis for the inventory and accounts receivable acquired from C. Its basis for C's share of inventory and accounts receivable is $13,000, the amount which the partnership is considered as having paid C in the exchange. Since the partnership is treated as having distributed C's share of inventory and accounts receivable to him, the partnership must decrease its basis for inventory and accounts receivable ($30,000) by $10,000, the basis of C's share treated as distributed to him, and then increase the basis for inventory and accounts receivable by $13,000 to reflect the purchase prices of the items acquired. Thus, the basis of the partnership inventory is increased from $21,000 to $24,000 in the transaction. (Note that the basis of property acquired in a section 751(b) exchange is determined under section 1012 without regard to any elections of the partnership. See § 1.732–1(e).) Further, the partnership realizes no capital gain or loss on the portion of the distribution treated as a sale under section 751(b) since, to acquire C's interest in the inventory and accounts receivable, it gave up money and assumed C's share of liabilities.

(2) *The part of the distribution not under section 751*(b).—In the remainder of the distribution to C which was not in exchange for C's interest in section 751 property, C received only other property as follows: $15,000 in depreciable property (with a basis to the partnership of $15,000) and $9,000 in money ($22,000 less $13,000 treated under subparagraph (1) of this paragraph of this example). Since this part of the distribution is not an exchange of section 751 property for other property, section 751(b) does not apply. Instead, the provisions which apply are sections 731 through 736, relating to distributions by a partnership. No gain or loss is recognized to the partnership on the distribution. (See section 731(b).) Further, the partnership makes no adjustment to the basis of remaining depreciable property unless an election under section 754 is in effect. (See section 734(a).) Thus, the basis of the depreciable property before the distribution, $42,000, is reduced by the basis of the depreciable property distributed, $15,000, leaving a basis for the depreciable property in the partnership of $27,000. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) as follows: Since the adjusted basis of the distributed property to the partnership had been $15,000, and is only $13,000 in C's hands (see paragraph (d)(2) of this example), the partnership will increase the basis of the depreciable property remaining in the partnership by $2,000 (the excess of the adjusted basis to the partnership of the distributed depreciable property immediately before the distribution over its basis to the distributee). Whether or not an election under section 754 is in effect, the basis for each of the remaining partner's partnership interests will be $38,000 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities each assumed).

(f) *Partnership trial balance.*—A trial balance of the AB partnership after the distribution in liquidation of C's entire interest would reflect the results set forth in the schedule below. Column I shows the amounts to be reflected in the records if an election is in effect under section 754 with respect to an optional adjustment under section 734(b) to the basis of undistributed partnership property. Column II shows the amounts to be reflected in the records where an election under section 754 is not in effect. Note that in column II, the total bases for the partnership assets do not equal the total of the bases for the partnership interests.

	I		II	
	Section 754, Election in effect		Section 754, Election not in effect	
	Basis	Fair market value	Basis	Fair market value
Cash	$5,000	$5,000	$5,000	$5,000
Accounts receivable	9,000	9,000	9,000	9,000
Inventory	24,000	30,000	24,000	30,000
Depreciable property	29,000	33,000	27,000	33,000
Land	9,000	9,000	9,000	9,000
Totals	$76,000	$86,000	$74,000	$86,000
Current liabilities	$15,000	$15,000	$15,000	$15,000
Mortgage	21,000	21,000	21,000	21,000
Capital:				
A	20,000	25,000	20,000	25,000
B	20,000	25,000	20,000	25,000
Totals	$76,000	$86,000	$76,000	$86,000

Example (3). (a) *Facts.*—Assume that the distribution to partner C in example (2) of this paragraph in liquidation of his entire interest in partnership ABC consists of $5,000 in cash and $20,000 worth of partnership inventory with a basis of $14,000.

(b) *Presence of section 751 property.*—For the same reason as stated in paragraph (b) of that example, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.*—In the distribution, C received his share of cash ($5,000) and his share of appreciated inventory items ($13,000). In addition, he received appreciated inventory with a fair market value of $7,000 (and with an adjusted basis to the partnership of $4,900) and $12,000 in money (liabilities assumed). C has relinquished his interest in $16,000 of depreciable property and $3,000 of land. Although C relinquished his interest in $3,000 of accounts receivable, such accounts receivable are inventory items and, therefore, that exchange was not an exchange of section 751 property for other property. Section 751 (b) applies only to the extent of the exchange of other property for section 751 property (i. e., depreciable property or land for inventory items). Assume that the partners agree that the $7,000 of inventory in excess of C's share was received by him in exchange for $7,000 of depreciable property.

(d) *Distributee partner's tax consequences.*—C's tax consequence on the distributions are as follows:

(1) *The section 751*(b) *sale or exchange.*—C is treated as if he had received his 7/16th share of the depreciable property in a current distribution. His basis for that share is $6,125 (42,000/48,000 of $1,000), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/16ths share of depreciable property to the partnership for $7,000, realizing a gain of $875.

(2) *The part of the distribution not under section 751*(b).—Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000, plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,125, the basis of property treated as distributed to C and sold by him to the partnership. Thus, C will have a basis of $25,875 for the remainder of his partnership interest. Of the $37,000 total distribution to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory with a fair market value of $13,000 (which had an adjusted basis to the partnership of $9,100) is limited to $8,875, the amount of the remaining basis for his partnership interest, $25,875, reduced by $17,000, the money received. Thus, C's total aggregate basis for the inventory received is $15,875 ($7,000 plus $8,875), and not its $14,000 basis in the hands of the partnership.

(e) *Partnership's tax consequences.*—The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751*(b) *sale or exchange.*—The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of the $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/16ths of C's interest in the depreciable property. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. Its basis for the depreciable property is $42,875 ($42,000 less $6,125, the basis of the 7/16ths share considered as distributed to C, plus $7,000, the partnership purchase price for this share).

(2) *The part of the distribution not under section 751* (b).—In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 9/16ths interest in depreciable property which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100, and C's basis for such inventory after distribution is only $8,875. The basis of the inventory remaining in the partnership must be increased by $225. Whether or not an

election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities now assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon that part of the distribution treated as a sale or exchange).

Example (4).—(a) *Facts.*—Assume the same facts as in example (3) of this paragraph, except that the partners did not identify the property which C relinquished in exchange for the $7,000 of inventory which he received in excess of his share.

(b) *Presence of section 751 property.*—For the same reasons stated in paragraph (b) of example (2) of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.*—The analysis stated in paragraph (c) of example (3) of this paragraph is the same in this example, except that, in the absence of a specific agreement among the partners as to the properties exchanged, C will be presumed to have sold to the partnership a proportionate amount of each property in which he relinquished an interest. Thus, in the absence of an agreement, C has received $7,000 of inventory in exchange for his release 7/19ths of the depreciable property and 7/19ths of the land. ($7,000, fair market value of property released, over $19,000, the sum of the fair market values of C's interest in the land and C's interest in the depreciable property.)

(d) *Distributee partner's tax consequences.*—C's tax consequences on the distribution are as follows:

(1) *The section 751* (b) *sale or exchange.*—C is treated as if he had received his 7/19ths shares of the depreciable property and land in a current distribution. His basis for those shares is $6,263 (51,000/57,000 of $7,000, their fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/19ths shares of depreciable property and land to the partnership of $7,000, realizing a gain of $737.

(2) *The part of the distribution not under section 751* (b).—Section 751(b) does not apply to the balance of the distribution. Before the distribution C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,263, the bases of C's shares of depreciable property and land treated as distributed to him and sold by him to the partnership. Thus, C will have a basis of $25,737 for the remainder of his partnership interest. Of the total $37,000 distributed to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory (with a fair market value of $13,000 and an adjusted basis to the partnership of $9,100) is limited to $8,737, the amount of the remaining basis for his partnership interest $25,737 less $17,000, money received). Thus, C's total

aggregate basis for the inventory he received is $15,737 ($7,000 plus $8,737), and not the $14,000 basis it had in the hands of the partnership.

(e) *Partnership's tax consequences.*—The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751* (b) *sale or exchange.*—The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/19ths of C's interest in the depreciable property and land. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. The bases of the depreciable property and land would be $42,737 and $9,000, respectively. The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $5,158 basis (42,000/48,000 of $5,895) for C's 7/19ths interest constructively distributed, and increased by $5,895 (16,000/19,000 of $7,000), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $1,105 basis (9,000/9,000 of $1,105) of the land constructively distributed to C, and increased by $1,105 (3,000/19,000 of $7,000), the portion of the purchase price allocated to the land.

(2) *The part of the distribution not under section 751*(b).—In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 12/19ths interests in depreciable property and land which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100 and C's basis for such inventory after the distribution is only $8,737. The basis of the inventory remaining in the partnership must be increased by the difference of $363. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon the part of the distribution treated as a sale or exchange).

Example (*5*). (a) *Facts.*—Assume that partner C in example (2) of this paragraph agrees to reduce his interest in capital and profits from ⅓ to ⅕ for a current distribution consisting of $5,000 in cash, and $7,500 of accounts receivable with a basis to the partnership of $7,500. At the same time, the total liabilities of the partnership are not reduced. Therefore, after the distribution, C's share of the partnership liabilities has been reduced by $4,800 from $12,000 (⅓ of $36,000) to $7,200 (⅕ of $36,000).

(b) *Presence of section 751 property.*—For the same reasons as stated in paragraph (b) of example (2) of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.*—C's interest in the fair market value of the partnership properties before and after the distribution can be illustrated by the following table:

Item	C's interest		C received		C relinquished
	Fair market value		Distribution of share	In excess of share	
	⅓ Before	⅓ After			
Cash	$5,000	$2,000	$3,000	$2,000	
(Liabilities assumed)	(12,000)	(7,200)		4,800	
Inventory items:					
Accounts receivable	3,000	300	2,700	4,800	
Inventory	10,000	6,000			4,000
Depreciable property	16,000	9,600			6,400
Land	3,000	1,800			1,200
Total	$25,000	$12,500	$5,700	$11,600	$11,600

Although C relinquished his interest in $4,000 of inventory and received $4,800 of accounts receivable, both items constitute section 751 property and C has received only $800 of accounts receivable for $800 worth of depreciable property or for an $800 undivided interest in land. In the absence of an agreement identifying the properties exchanged, it is presumed C received $800 for proportionate shares of his interests in both depreciable property and land. To the extent that inventory was exchanged for accounts receivable, or to the extent cash was distributed for the release of C's interest in the balance of the depreciable property and land, the transaction does not fall within section 751(b) and is a current distribution under section 732(a). Thus, the remaining $6,700 of accounts receivable are received in a current distribution.

(d) *Distributee partner's tax consequences.*—C's tax consequences on the distribution are as follows:

(1) *The section 751* (b) *sale or exchange.*—Assuming that the partners paid $800 worth of accounts receivable for $800 worth of depreciable property, C is treated as if he received the depreciable property in a current distribution, and his basis for the $800 worth of depreciable property is $700 (42,000/48,000 of $800, its fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his $800 share of depreciable property to the partnership for $800. On the sale of the depreciable property, C realizes a gain of $100. If, on the other hand, the partners had agreed that C exchanged an $800 interest in the land for $800 worth of accounts receivable, C would realize no gain or loss, because under paragraph (b)(2)(iii) of this section his basis for the land sold would be $800. In the absence of an agreement, the basis for the depreciable property and land (which C is considered as having received in a current distribution and then sold back to the partnership) would be $716 (51,000/57,000 of $800). In that case, on the sale of the

balance of the $800 share of depreciable property and land, C would realize $84 of gain ($800 less $716).

(2) *The part of the distribution not under section* 751(b). Section 751(b) does not apply to the balance of the distribution. Under section 731, C does not realize either gain or loss on the balance of the distribution. The adjustments to the basis of C's interest are illustrated in the following table:

	If accounts receivable received for depreciable property	If accounts receivable received for land	If there is no agreement
Original basis for C's interest	$32,000	$32,000	$32,000
Less basis of property distributed prior to section 751 (b) sale or exchange	−700	−800	−716
	31,300	31,200	31,284
Less money received in distribution	−9,800	−9,800	−9,800
	21,500	21,400	21,484
Less basis of property received in a current distribution under section 732	−6,700	−6,700	−6,700
Resulting basis for C's interest	$14,800	$14,700	$14,784

C's basis for the $7,500 worth of accounts receivable which he received in the distribution will be $7,500, composed of $800 for the portion purchased in the section 751(b) exchange, plus $6,700, the basis carried over under section 732(a) for the portion received in the current distribution.

(e) *Partnership's tax consequences.*—The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751*(b) *sale or exchange.*—The partnership realizes no gain or loss in the section 751 sale or exchange because it had a basis of $800 for the accounts receivable for which it received $800 worth of other property. If the partnership agreed to purchase $800 worth of depreciable property, the partnership basis of depreciable property becomes $42,100 ($42,000 less $700 basis of property constructively distributed to C, plus $800, price of property purchased). If the partnership purchased land with the accounts receivable, there would be no change in the basis of the land to the partnership because the basis of land distributed was equal to its purchase price. If there were no agreement, the basis of the depreciable property and land would be $51,084 (depreciable property, $42,084 and land $9,000). The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $590 basis (42,000/48,000 of $674) for C's $674 interest constructively distributed, and increased by $674 (6,400/7,600 of $800), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $126 basis (9,000/9,000 of $126) of the land constructively distributed to C, and increased by $126 (1,200/7,600 of $800), the portion of the purchase price allocated to the land.

(2) *The part of the distribution not under section 751*(b).—The partnership will realize no gain or loss in the balance of the distribution under section 731. Since the property in C's hands after the distribution will have the same basis it had in the partnership, the basis of partnership property remaining in the partnership after the distribution will not be adjusted (whether or not an election under 754 is in effect).

§ 1.752 STATUTORY PROVISIONS; TREATMENT OF CERTAIN LIABILITIES.

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) DECREASED 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.

§ 1.752–1 TREATMENT OF CERTAIN LIABILITIES—(a) *Increase in partner's liabilities.*—(1) Where the liabilities of a partnership are increased, and each partner's share of such liabilities is thereby increased, the amount of each partner's increase shall be treated as a contribution of money by that partner to the partnership. For example, partnership AB borrows $1,000. If A and B are equal partners, the basis of the partnership interest of each is increased by $500 since each is considered under section 752(a) to have contributed that amount of money to the partnership.

(2) Any increase in a partner's individual liabilities because of the assumption by him of partnership liabilities shall also be considered as a contribution of money by him to the partnership. For example, equal partnership AB owns real property with an adjusted basis to the partnership of $1,000, a fair market value of $800, and which is subject to a mortgage of $400 which the partnership has not assumed. The mortgage is considered as a liability of the partnership under section 752(c). Since A and B each share one-half thereof, under section 752(a) the liability of each has been increased $200. Under section 722 such $200 increase is reflected in the basis of each partner for his interest. The real property is distributed by the partnership to A. Under the provisions of section 733(2), there is a net decrease of $800 in A's basis for his partnership interest. This amount is computed as follows: The basis of A's partnership interest is decreased in the distribution by $1,000 (the partnership basis for the distributed property) and further decreased under section 752(b) by $200 (the decrease in A's share of partnership liabilities) and increased under section 752(a) by $400 (the increase in A's individual liability

by reason of section 752(c)). Conversely, the basis of B's partnership interest is decreased by $200 since the distribution of the real property to A resulted in a decrease in B's share of the partnership liability under section 752(b).

(b) *Decrease in partner's liabilities.*—(1) Where the liabilities of a partnership are decreased, and each partner's share of such liabilities is thereby decreased, the amount of the decrease shall be treated as a distribution of money to the partner by the partnership. For example, partnership AB, in which A and B are equal partners, repays an obligation of $10,000. The repayment reduces each partner's share of partnership liabilities by $5,000 and is considered a distribution of money which reduces the basis of each partner's interest in the partnership by that amount. For the effect of a discharge of indebtedness on the basis of partnership property, see sections 108 and 1017.

(2) Where a partnership assumes the separate liabilities of a partner or a liability to which property owned by such partner is subject (see paragraph (c) of this section), the amount of the decrease in such partner's liabilities is treated as a distribution of money by the partnership to such partner. For example, partner A contributes property with a basis of $1,000 to partnership ABC in exchange for a one-third interest in the partnership. The property is subject to a mortgage of $150. (It is immaterial whether the mortgage is assumed by the partnership. See section 752(c).) The basis of A's partnership interest is $900, computed as follows: $1,000, A's basis for the contributed property, reduced by $100, two-thirds of A's original liability of $150 now attributable to partners B and C and reflected in their bases under the provisions of paragraph (a) of this section.

(c) *Liability to which property is subject.*—Where property subject to a liability is contributed by a partner to a partnership, or distributed by a partnership to a partner, the amount of the liability, to an extent not exceeding the fair market value of the property at the time of the contribution or distribution, shall be considered as a liability assumed by the transferee. For example, A contributes property with a basis to him of $1,000 to equal partnership AB. The property is subject to a mortgage of $2,500 and its value exceeds $2,500. Under paragraph (b) of this section, A will be treated as receiving a distribution in money of $1,250, one-half of the liability of $2,500 assumed by the partnership. Since the basis of A's partnership interest is $1,000 (the basis of the property contributed by him), the distribution to him of $1,250 results in his realizing a capital gain of $250 under section 731(a). A's basis for his partnership interest is zero. Although as a partner A has a $1,250 share of the $2,500 partnership liability, this $1,250 is not added to the basis of A's partnership interest since it does not represent an increase in liabilities as to him.

(d) *Sale or exchange of a partnership interest.*—Where there is 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. For example, if a partner sells his interest in a partnership for $750 cash and at the same time transfers to the purchaser his share of partnership liabilities amounting to $250, the amount realized by the seller on the transaction is $1,000.

(e) *Partner's share of partnership liabilities.*—A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits. The provisions of this paragraph may be illustrated by the following example:

Example. G is a general partner and L is a limited partner in partnership GL. Each makes equal contributions of $20,000 cash to the partnership upon its formation. Under the terms of the partnership agreement, they are to share profits equally but L's liabilities are limited to the extent of his contribution. Subsequently, the partnership pays $10,000 for real property which is subject to a mortgage of $5,000. Neither the partnership nor any of the partners assume any liability on the mortgage. The basis of such property to the partnership is $15,000. The basis of G and L for their partnership interests is increased by $2,500 each, since each partner's share of the partnership liability (the $5,000 mortgage) has increased by that amount. However, if the partnership had assumed the mortgage so that G had become personally liable thereunder, G's basis for his interest would have been increased by $5,000 and L's basis would remain unchanged.

(f) *Limitation.*—In determining the amount of liabilities for the purposes of section 752 and this section, the amount of an indebtedness is to be taken into account only once, even though a partner (in addition to his liability for such indebtedness as a partner) may be separately liable therefor in a capacity other than as a partner.

§ 1.753 Statutory Provisions; Partner Receiving Income in Respect of Decedent.

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.

§ 1.753–1 Partner Receiving Income in Respect of Decedent.—(a) *Income in respect of a decedent under section 736 (a).*—All payments coming within the provisions of section 736(a) made by a partnership to the estate or other successor in interest of a deceased partner are considered income in respect of the decedent under section 691. The estate or other successor in interest of a deceased partner shall be considered to have received income in respect of a decedent to the extent that amounts are paid by a third person in exchange for rights to future payments from the partnership under section 736(a). When a partner who is receiving payments under section 736(a) dies, section

753 applies to any remaining payments under section 736(a) made to his estate or other successor in interest.

(b) *Other income in respect of a decedent.*—When a partner dies, the entire portion of the distributive share which is attributable to the period ending with the date of his death and which is taxable to his estate or other successor constitutes income in respect of a decedent under section 691. This rule applies even though that part of the distributive share for the period before death which the decedent withdrew is not included in the value of the decedent's partnership interest for estate tax purposes. See § 1.706–1(c)(3).

(c) *Example.* The provisions of this section may be illustrated by the following example:

Example. A and the decedent B were equal partners in a business having assets (other than money) worth $40,000 with an adjusted basis of $10,000. Certain partnership business was well advanced towards completion before B's death and, after B's death but before the end of the partnership year, payment of $10,000 was made to the partnership for such work. The partnership agreement provided that, upon the death of one of the partners, all partnership property, including unfinished work, would pass to the surviving partner, and that the surviving partner would pay the estate of the decedent the undrawn balance of his share of partnership earnings to the date of death, plus $10,000 in each of the three years after death. B's share of earnings to the date of his death was $4,000, of which he had withdrawn $3,000. B's distributive share of partnership income of $4,000 to the date of his death is income in respect of a decedent (although only the $1,000 undrawn at B's death will be reflected in the value of B's partnership interest on B's estate tax return). Assume that the value of B's interest in partnership property at the date of his death was $22,000, composed of the following items: B's one-half share of the assets of $40,000, plus $2,000, B's interest in partnership cash. It should be noted that B's $1,000 undrawn share of earnings to the date of his death is not a separate item but will be paid from partnership assets. Under the partnership agreement, A is to pay B's estate a total of $31,000. The difference of $9,000 between the amount to be paid by A ($31,000) and the value of B's interest in partnership property ($22,000) comes within section 736(a) and, thus, also constitutes income in respect of a decedent. (However, the $17,000 difference between the $5,000 basis for B's share of the partnership property and its $22,000 value at the date of his death does not constitute income in respect of a decedent.) If, before the close of the partnership taxable year, A pays B's estate $11,000, of which they agree to allocate $3,000 as the payment under section 736(a), B's estate will include $7,000 in its gross income (B's $4,000 distributive share plus $3,000 payment under section 736(a)). In computing the deduction under section 691(c), this $7,000 will be considered as the value for estate tax purposes of such income in respect of a decedent, even though only $4,000 ($1,000 of distributive share not withdrawn, plus $3,000, payment under section 736(a)) of this amount can be identified on the estate tax return as part of the partnership interest.

(d) *Effective date.*—The provisions of section 753 apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954. See section 771(b)(4) and § 1.771(b)(4).

§ 1.754 STATUTORY PROVISIONS; MANNER OF ELECTING OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.

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 maner 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.

§ 1.754–1 TIME AND MANNER OF MAKING ELECTION TO ADJUST BASIS OF PARTNERSHIP PROPERTY.—(a) *In general.*—A partnership may adjust the basis of partnership property under section 734(b) and 743(b) if it files an election in accordance with the rules set forth in paragraph (b) of this section. An election may not be filed to make the adjustments provided in either section 734(b) or section 743(b) alone, but such an election must apply to both sections. An election made under the provisions of this section shall apply to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent partnership taxable years unless the election is revoked pursuant to paragraph (c) of this section.

(b) *Method of making election.*—An election under this section to adjust the basis of partnership property under sections 734(b) and 743(b) shall be made in a written statement filed with the partnership return for the first taxable year to which the election applies (or within 90 days after the promulgation of the regulations under section 754). The statement shall (1) set forth the name and address of the partnership making the election, (2) be signed by any one of the partners, and (3) contain a declaration that the partnership elects to apply the provisions of section 734(b) and section 743(b).

(c) *Revocation of election.*—A partnership having an election in effect under this section may revoke such election with the approval of the district director for the district in which the partnership return is required to be filed. A partnership which wishes to revoke such an election shall file with the district director for the district in which the partnership return is required to be filed an application setting forth the grounds on which the revocation is desired. The application shall be filed not later than 30 days after the close of the partnership taxable year with respect to which revocation is intended to take effect and shall be signed by any one of the partners. Examples of situations which may be considered sufficient reason for approving an application for revocation include a change in the nature of the partnership business, a substantial increase in the assets of the partnership, a change in the character of partnership assets, or an increased fre-

quency of retirements or shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election. However, no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.

§ 1.755 STATUTORY PROVISIONS; RULES FOR ALLOCATION OF BASIS.

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.

§ 1.755–1 RULES FOR ALLOCATION OF BASIS.—(a) *General rule.*—(1) (i) A partnership which has elected under section 754 must adjust the basis of partnership property under the provisions of section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property) and section 743(b) (relating to the optional adjustment to the basis of partnership property where a partnership interest is transferred). The amount of the increase or decrease (as determined in those sections) in the adjusted basis of the partnership property shall first be divided, under paragraph (b) of this section, between the two classes of property described in section 755(b). Then, the portion of the increase or decrease allocated to each class shall be further allocated to the bases of the properties within the class in a manner which will reduce the difference between the fair market value and the adjusted basis of partnership properties. In the alternative, any increase or decrease may be allocated in any other manner approved by the district director under subparagraph (2) of this paragraph.

(ii) If there is an increase in basis to be allocated to partnership assets, such increase must be allocated only to assets whose values exceed their bases and in proportion to the difference between the value and basis of each. No increase shall be made to the basis of any asset the adjusted basis of which equals or exceeds its fair market value.

(iii) If there is a decrease in basis to be allocated to partnership assets, such decrease must be allocated to assets whose bases exceed their value and in proportion to the difference between the basis and value of each. No decrease shall be made to the basis of any asset, the fair market value of which equals or exceeds its adjusted basis.

(iv) The application of the rules with respect to the allocation of an adjustment in basis under subdivisions (ii) and (iii) of this subparagraph requires that a portion of such adjustment be allocated to partnership good will, to the extent that good will exists and is reflected in the value of the property distributed, the price at which the partnership interest is sold, or the basis of the partnership interest determined under section 1014, in accordance with the difference between such value of the good will and its adjusted basis at the time of the transaction.

(2) If a partnership (or a partner electing under section 732 (d)) desires to adjust the basis of assets under section 734(b) or 743(b) in a manner other than that prescribed in subparagraph (1) of this paragraph, it must file an application for permission to use such method with the district director no later than 30 days after the close of the partnership taxable year in which the proposed adjustment is to be made. The application must describe the proposed adjustments in detail and set forth the reasons for the desired use of the other method. Under section 755(a)(2), the district director may permit the partnership to increase the bases of some partnership properties and decrease the bases of other partnership properties under section 734(b) or 743(b). Each increase or decrease to the basis of an asset must reduce or eliminate the difference between such basis and the value of the asset. The net amount of all such adjustments must equal the amount of the adjustment under section 734(b) or 743(b). Adjustments that both increase and decrease the basis of partnership assets will be permitted by the district director only upon a satisfactory showing of the values for partnership assets used by the parties to determine the price at which a partnership interest was sold, the value of the decedent's partnership interest at date of death (or at the alternate valuation date, if used), or the amount of a distribution.

(b) *Special rules.*—For the purposes of applying section 755, all partnership property shall be classified into two categories: capital assets and property described in section 1231(b) (certain property used in the trade or business), or any other property of the partnership.

(1) *Distributions.*—(i) Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property under section 734(b)(1)(B) or (b)(2)(B), such adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, when the partnership adjusted basis of distributed capital assets and section 1231(b) property immediately prior to distribution exceeds the basis of such property to the distributee partner (as determined under section 732), the basis of the undistributed capital assets and section 1231(b) property remaining in the partnership shall be increased by an amount equal to such excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital assets and section 1231(b) property exceeeds the partnership adjusted basis of such

property immediately prior to the distribution, the basis of the undistributed capital assets and section 1231(b) property remaining in the partnership shall be decreased by an amount equal to such excess. Similarly, where there is a distribution of partnership property other than capital assets and section 1231(b) property, and the basis of such other property to the distributee partner (as determined under section 732) is not the same as the partnership adjusted basis of such property immediately prior to distribution, the adjustment shall be made only to undistributed property of the same category remaining in the partnership.

(ii) Where there is a distribution resulting in an adjustment under section 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, such adjustment must be allocated only to capital assets or section 1231(b) property.

(2) *Transfers.*—Where there is a basis adjustment under section 743(b) arising from a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, the amount of the adjustment shall be allocated between the two classes of property described in section 755(b) and then the amount allocated to each class shall be further allocated under the rules of paragraph (a)(1) of this section. Thus, to the extent that an amount paid by a purchaser of a partnership interest (or the basis of the partnership interest to the estate or other successor in interest of a deceased partner) is attributable to the value of capital assets and section 1231(b) property, any difference between the amount so attributable and the transferee partner's share of the partnership basis of such property shall constitute a special basis adjustment with respect to partnership capital assets and section 1231(b) property. Similarly, any such difference attributable to any other property of the partnership shall constitute a special basis adjustment with respect to such property.

(3) *Limitation on decrease of basis.*—Where a decrease in the basis of partnership assets is required under section 734(b)(2) and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of such property shall be reduced to zero (but not below zero), and the balance of the decrease in basis shall be made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(4) *Carryover of adjustment.*—Where, in the case of a distribution, an increase or decrease required under paragraph (a) of this section in the basis of undistributed partnership property cannot be made because the partnership owns no property of the character required to be adjusted, or because the adjustment has been limited under subparagraph (3) of this paragraph, the adjustment shall be made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Assume that partnership ABC has three assets: X, a capital asset with an adjusted basis of $1,000 and a value of $1,500; Y, a depreciable asset with an adjusted basis of $1,000 and a value of $900; and Z, inventory items with an adjusted basis of $700 and a value of $600. A sells his interest to

D (when an election under 754 is in effect) for $1,000 (⅓ of $3,000, the total value of partnership assets). D's share of the adjusted basis of partnership property is $900 (⅓ of $2,700). Therefore, under section 743(b), D has a special basis adjustment of $100 ($1,000 minus $900). This adjustment must be allocated entirely to property X, since such allocation will have the effect of reducing the difference between the value and basis of such asset. Therefore, D has a special basis adjustment of $100 with respect to property X, which now has a special basis to him of $1,100. No part of the adjustment is made to depreciable property Y or inventory items Z, since any such adjustment would increase the difference between the basis and value of each such asset.

Example (2). Assume the same facts as in example (1) of this paragraph except that capital asset X has a value of $1,500, depreciable property Y has a value of $1,100, and inventory items Z have a value of only $400. Therefore, under section 743(b), D has a special basis adjustment of $100, the excess of D's basis for his interest in the partnership ($1,000) over his share of the adjusted basis of partnership property ($900). This $100 adjustment must be allocated entirely to capital asset X and depreciable property Y in proportion to the difference between the value and basis of each since such allocation has the effect of reducing the difference between the value and basis of each such asset. Therefore, D has a special basis adjustment of $83 ($500/$600 of $100) with respect to capital asset X, which now has a special basis to him of $1,083, and of $17 ($100/$600 of $100) with respect to depreciable property Y, which now has a special basis to him of $1,017. No part of the adjustment is made to inventory items Z, since any such adjustment would increase the difference between the basis of such asset and its value.

Example (3). Assume that partnership EFG has three assets: X, a capital asset with an adjusted basis of $1,000 and a value of $1,500; Y, a depreciable asset with an adjusted basis of $1,000 and a value of $700; and Z, inventory items with an adjusted basis of $700 and a value of $800. E sells his interest to H (when an election under section 754 is in effect) for $1,000 (⅓ of $3,000, the total value of the partnership assets). H's share of the adjusted basis of partnership property is $900 (⅓ of $2,700). Therefore, H has a special basis adjustment of $100 ($1,000 minus $900) under section 743(b). Since, of the total $300 difference between the value and the adjusted basis of all partnership property, $200 ($500, appreciation in value of X, minus $300, depreciation in value of Y) is attributable to the class of capital assets and depreciable property, and $100 (appreciation in value of inventory items Z) to the class of other property, H's special basis adjustment of $100 must be allocated ⅔ to capital assets and depreciable property and ⅓ to other property (inventory). The $67 increase (⅔ of $100) to be allocated to capital assets and depreciable property must further be allocated so as to reduce the difference between the value and basis of such assets. This can be done only by allocating the entire $67 increase to capital asset X (the basis

of which is less than its value), and no part of the increase to depreciable property Y (the basis of which exceeds its value). Therefore, H has a special basis adjustment of $67 for capital asset X, which now has a special basis to him of $1,067; he has no special basis adjustment for depreciable property Y. He also has a special basis adjustment of $33 (⅓ of $100) for inventory items Z, the special basis of which is now $733.

DEFINITIONS

§ 1.761 STATUTORY PROVISIONS; 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.

§ 1.761–1 TERMS DEFINED.—(a) *Partnership.*—(1) *In general.*—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 a corporation or a trust or estate within the meaning of the Internal Revenue Code of 1954. The term "partnership" is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships. See section 7701(a)(2). See regulations under section 7701(a)(1), (2), and (3) for the description of those unincorporated organizations taxable as corporations or trusts. A joint undertaking merely to share expenses is not a partnership. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they are not partners. Mere coownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share

of the crops, they do not necessarily create a partnership thereby. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if coowners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.

(2) *Exclusion of certain partnerships from provisions of subchapter K.*—(i) *In general.*—Under the conditions set forth in this paragraph, an unincorporated organization described in subdivision (ii) or (iii) of this subparagraph may be excluded from the application of all or a part of the provisions of subchapter K. Such organization must be availed of for investment purposes only and not for the active conduct of a business, or for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income. Any syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association, does not fall within these provisions.

(ii) *Investing partnership.*—Where the participants in the joint purchase, retention, sale, or exchange of investment property—

(*a*) Own the property as coowners,

(*b*) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(*c*) Do not actively conduct business for joint profit, or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in subdivision (iv) of this subparagraph.

(iii) *Operating agreements.*—Where the participants in the joint production, extraction, or use of property—

(*a*) Own the property as coowners, either in fee or under a lease or other form of contract granting exclusive operating rights, and

(*b*) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

(*c*) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than one year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in subdivision (iv) of this subparagraph. However, the preceding sentence does not apply to any unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization.

(iv) *Method of election.*—(*a*) *Complete exclusion from subchapter K.*—An unincorporated organization which wishes to be excluded from all of subchapter K must make the election provided in section 761(a) in a statement attached to a partnership return filed with the district director for the district in which the organization has its principal office or place of business. Such return shall be properly executed and shall contain, in lieu of the information required thereon, only the name and address of the organization. The statement attached to the return shall include the names and addresses of all the members of the organization; a statement that the organization qualifies under subdivisions (i) and either (ii) or (iii) of § 1.761–1(a)(2) and elects to be excluded from all of subchapter K; and a copy of the agreement under which the organization operates if written (or a summary thereof if oral). Unless, within 90 days after the formation of the organization (or after the promulgation of the regulations under subchapter K, whichever is later), any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail, the election to be excluded will be approved. Such election is irrevocable as long as the organization remains qualified under subdivisions (i) and either (ii) or (iii) of this subparagraph.

(*b*) *Partial exclusion from subchapter K.*—An unincorporated organization which wishes to be excluded from only certain sections of subchapter K must submit to the Commissioner, no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired, a request for permission to be excluded from certain provisions of subchapter K. The request shall set forth the sections of subchapter K from which exclusion is sought and shall state that such organization qualifies under subdivisions (i) and either (ii) or (iii) of § 1.761–1(a)(2), and that the members of the organization elect to be excluded to the extent indicated. Such exclusion shall be effective only upon approval of the election by the Commissioner and subject to the conditions he may impose.

(v) *Information to be filed by organizations excluded under section 761.*—(*a*) An organization excluded from all of subchapter K shall file annually with the Commissioner of Internal Revenue, Midwest Service Center, Kansas City, Missouri, a Form 1099 for each person who was a member of the organization during any part of the calendar year. Such form shall show the name and address of the member (under "To Whom Paid") and the name and address of the organization (under "By Whom Paid"). In lieu of "Kind and Amount of Income Paid", each such form shall state "Filed under section 761(a)" and the principal activity of the organization. Such organization need not file Form 1065 annually.

(*b*) Organizations partially excluded from subchapter K shall file partnership returns containing such information as the Commissioner may require upon the granting of the partial exclusion under section 761(a).

(b) *Partner.*—The term "partner" means a member of a partnership.

(c) *Partnership agreement.*—For the purposes of subchapter K, a partnership agreement includes the original agreement and any mod-

ifications thereof agreed to by all the partners or adopted in any other manner provided by the partnership agreement. Such agreement or modifications can be oral or written. A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return. As to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law shall be considered to constitute a part of the agreement.

(d) *Liquidation of partner's interest.*—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. A series of distributions will come within the meaning of this term whether they are made in one year or in more than one year. Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made. For the basis of property distributed in one liquidating distribution, or in a series of distributions in liquidation, see section 732(b). A distribution which is not in liquidation of a partner's entire interest, as defined in this paragraph, is a current distribution. Current distributions, therefore, include distributions in partial liquidation of a partner's interest, and distributions of the partner's distributive share. See § 1.731–1 (a)(1)(ii).

Effective Date For Subchapter

§ 1.771 STATUTORY PROVISIONS; 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 prop-

erty 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.

§ 1.771–1 EFFECTIVE DATE.—(a) *General rule.*—Except as provided in paragraph (b) or (c) of this section, the provisions of subchapter K shall apply to any taxable year of a partnership beginning after December 31, 1954, and to any part of a partner's taxable year falling within such partnership taxable year. The provisions of the Internal Revenue Code of 1939 relating to partnerships shall apply to any taxable year of a partnership beginning before January 1, 1955, and to any part of a partner's taxable year falling within such partnership taxable year. If a partnership and the partners are on different taxable years, subchapter K shall become effective at the same time both for the partnership and for the partners.

(b) *Special rules.*—Certain provisions of section 771 apply after specific dates in 1954, as follows:

(1) *Adoption of taxable year.*—Section 706(b) (relating to the adoption of taxable years by partners and partnerships), shall apply to any partnership which adopts or changes to, and any partner who changes to, a taxable year beginning on or after April 2, 1954. For the purpose of applying this subparagraph, the rules of section 708 (relating to the continuation of partnerships) shall apply. For example, if two or more partnerships merge after April 1, 1954, and the new partnership uses the taxable year of the partnership of which it is deemed to be the successor under section 708(b)(2)(A), it will not need prior approval to continue to use such taxable year even though such year may be different from the taxable years of the partners. Such a partnership is not "adopting" or "changing" its taxable year.

(2) *Property distributed by a partnership.*—Section 735(a), relating to the character of gain or loss on disposition of property distributed by a partnership to a partner, shall apply only to property distributed after March 9, 1954. Although a partnership whose taxable year begins before January 1, 1955, generally will be subject to the provisions of the Internal Revenue Code

of 1939, any unrealized receivables or inventory items distributed by any such partnership after March 9, 1954, will be subject to the provisions of section 735(a), and the gain or loss on the subsequent disposition of such property will be ordinary gain or loss rather than capital gain or loss. In the case of property distributed before March 10, 1954, section 735(a) will not apply, even though the property is disposed of by the distributee partner after that date, unless the partnership elects under paragraph (c) of this section to apply section 735.

(3) *Unrealized receivables and inventory items.*—Section 751 (providing for the realization of ordinary income on certain transfers or distributions of unrealized receivables or substantially appreciated inventory items) shall be applicable to any such transfer or distribution occurring after March 9, 1954. For the purpose of applying section 751 in the case of a taxable year beginning before January 1, 1955, a partnership or partner may elect to treat as applicable any other section of subchapter K. See § 1.751–1(f).

(4) *Partner receiving income in respect of a decedent.*—Section 753, which provides that 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, shall apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954.

(c) *Optional treatment of certain distributions.*—(1) For a partnership taxable year beginning after December 31, 1953, and before January 1, 1955, a partnership may elect to apply the rules of certain sections of subchapter K with respect to current distributions made by the partnership in such year. These sections are 731, 732(a), (c), and (e), 733, 735, and 751(b), (c), and (d). If an election is made, it shall apply to the partnership and all its members for all current distributions made by the partnership during the taxable year. Such distributions shall also be subject to the rules of sections 705 (relating to determination of basis of a partner's interest), 752 (relating to treatment of certain liabilities), and 761(d) (relating to the definition of liquidation of a partner's interest), to the extent that such sections apply to current distributions.

(2) An election under this paragraph shall be made by a statement filed with the partnership return for the taxable year to which such election applies, or filed within 90 days after the promulgation of the regulations under section 771, whichever date is later. The statement shall be signed by all members of the partnership and the election once made shall be binding on the partnership and on all of its members.

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved May 23, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Filed by the Division of the Federal Register May 23, 1956, 4:51 p. m.)

PART III.—DEFINITIONS

SECTION 761.—TERMS DEFINED

26 CFR 1.761–1: Terms Defined.

Extension of time, allowed unincorporated organizations entitled to make the election under section 761(a) of the Internal Revenue Code of 1954 for filing any partnership returns or other information in lieu thereof. See Rev. Proc. 56–9, page 1025.

SUBCHAPTER L.—INSURANCE COMPANIES

PART I.—LIFE INSURANCE COMPANIES

SUBPART A.—1955 FORMULA

SECTION 801.—DEFINITION OF LIFE INSURANCE COMPANY

(Also Part II, Section 201; Regulations 118, Section 39.201–3.) Rev. Rul. 56–106

A life insurance company which disposes of its insurance business under a reinsurance agreement with another company, but which continues its corporate existence under local law for an extended period thereafter for the purpose of winding up and liquidating its affairs, ceases to be a life insurance company on the effective date of such agreement and thereafter becomes taxable as an ordinary corporation.

Advice has been requested whether, in the case of a life insurance company, as defined in section 801 of the Internal Revenue Code of 1954, which transfers all of its insurance business and assets to another insurance company in pursuance of a reinsurance agreement between the two companies, and which ceases thereafter to engage in the business of issuing insurance contracts, but continues its corporate existence for an extended period subsequent to the effective date of such agreement for the purpose of liquidating and winding up its affairs, such life insurance company retains its identity as a life insurance company under section 801 of the 1954 Code.

In the instant case *M* company, prior to the date of the transaction described below, qualified as a "life insurance company" as defined by section 801 of the Code. It filed its Federal income tax returns on the calendar year basis. Effective as of the close of business September 30, 1954, *M* company, pursuant to a reinsurance agreement with *N* company, transferred to the latter all of its assets, including the investments underlying its life insurance reserves. *N* company, under the terms of the agreement, assumed all obligations of *M* company to the latter's policyholders and, as additional consideration for the

transfer, agreed to pay to *M* company certain fixed or determinable amounts described in the agreement. Under the terms of the agreement such amounts, plus interest on the unpaid balance, will be paid to *M* company over a period of years. After the effective date of the reinsurance agreement, *M* company ceased to engage in the business of issuing insurance contracts, but its corporate existence under local law will be continued indefinitely for the purpose of liquidating and winding up its affairs.

Section 801 of the 1954 Code defines "life insurance company," in part, as follows:

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. * * *

After the effective date of the reinsurance agreement, *M* company will have no "life insurance reserves" as defined in section 803(b) of the 1954 Code; nor will it have any unearned premiums and unpaid losses on health or accident policies since the entire business, including these items, was transferred to *N* company. Thus, *M* company can no longer meet the conditions of the definition of "life insurance company" contained in section 801. Accordingly, *M* company will not be taxable as a life insurance company after the effective date of the reinsurance agreement with *N* company, but will be taxable under the provisions of the 1954 Code applicable to ordinary corporations. Cf. *Reserve Loan Life Ins. Code of Texas*, 4 T. C. 732, acquiescence C. B. 1945, 6; *The Royal Highlanders*, 1 T. C. 184, acquiescence C. B. 1943, 20.

SECTION 803.—OTHER DEFINITIONS AND RULES

(Also Section 243.) Rev. Rul. 56-107

Interest payments made on certificates of indebtedness issued and sold by a mutual life insurance company to certain corporations, under factual circumstances which disclose that the relationship between the insurance company and the certificate holders is a debtor-creditor relationship, constitute "interest paid" on indebtedness of the insurance company within the meaning of section 803(f) of the Internal Revenue Code of 1954. It follows, such amounts do not constitute dividends, within the purview of section 243(a) of the Code, when received by the corporate holders of the certificates.

Information has been requested regarding the tax treatment to be accorded the interest paid to the owners of certificates of indebtedness issued and sold by a mutual life insurance company under the following circumstances:

A mutual insurance company, which qualifies as a "life insurance company" within the meaning of section 801 of the Internal Revenue

Code of 1954, is authorized and licensed to do business in a certain state. In order to have sufficient capital (guaranty fund and surplus) to be able to qualify to engage in the life insurance business in other states, the company, under resolution of its board of directors and pursuant to the provisions of state statutes, issued and sold to two other corporations certificates of indebtedness in the total principal amount of $400x$ dollars. The certificates bear interest at the rate of four percent per year on the principal sum and five percent on any and all overdue interest. The certificates of indebtedness are to be redeemed to the extent of $150x$ dollars when the company's surplus equals or exceeds $300x$ dollars and in full when the company's surplus equals or exceeds $500x$ dollars. No dividend will be voted or paid to members or policyholders at any time there occurs a default in the payment of interest or default in the redemption of such certificates.

The certificates which are registered on the company's books will pass only by transfer on such books. In the event of liquidation, the registered owners of the certificates shall be paid in full the unpaid principal and interest, before any dividends are paid to the members or policyholders, to the extent that the company's reserves are not impaired. There is no provision in the certificates for voting rights to the owners.

The issues for consideration briefly stated are:

(1) Whether, in computing its "reserve and other policy liability deduction" within the meaning of section 804(a) of the Code, the interest paid by the company during the taxable year to the owners of the certificates of indebtedness may be treated as interest paid within the meaning of section 803(f) of the Code; and (2) whether, in computing their Federal income tax, the two corporations holding the certificates of indebtedness may deduct 85 percent of the "interest" paid to them under the provisions of section 243(a) of the Code.

Section 803(f) of the Code defines the term "interest paid" as meaning:

> (1) All interest paid or accrued within the taxable year 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.

Section 803(g) of the Code relates to the computation of the taxable income of life insurance companies and provides that the term "taxable income" means its gross income less the deductions for tax free interest, investment expenses, real estate expenses, certain depreciation deductions allowed by section 167 of the Code, and the special deductions allowed by part VIII of subchapter B (except section 248) of the Code.

There is no provision under section 803(g) of the Code for the deduction of "interest paid" as an ordinary and necessary business expense within the meaning of section 162 or for the deduction as "interest paid" under section 163 of the Code in computing the taxable

income of an insurance company. The "interest paid" as defined in section 803(f) is employed in the computation of the "reserve and other policy liability deduction" defined in section 804 of the Code and in the computation of "required interest" as defined in section 805(d) of the Code and used in determining the amount of the reserve interest credit under section 805 (b) of the Code.

It is well established that a security, regardless of the name it is given, may represent either a share of stock or evidence of indebtedness, depending upon the facts in the particular case. Thus, the owner is either a creditor or a shareholder.

The principles established in Revenue Ruling 55–240, C. B., 1955–1, 406, relative to the determination of the relationship of the certificate holders (shareholders) to the insurance company referred to therein, are considered to be applicable in determining whether the certificate holders in the instant case are creditors or shareholders. It was pointed out that where the certificate holders (shareholders) of a mutual company have (1) voting rights equal to or superior to those of policyholders, (2) equal representation with the policyholders on the board of directors, and (3) the rights to participate in the earnings of the company and the distribution of the company's assets upon liquidation, their relationship to the company is in the nature of that of stockholders.

The facts in the instant case do not indicate that the certificate holders qualify as stockholders of the insurance company under the above-mentioned criteria. Therefore, they are creditors. Accordingly, it is held that the payments made thereto by the insurance company constitute "interest paid" on indebtedness within the meaning of section 803(f) of the Code. It follows, since the two corporations holding the certificates of indebtedness are creditors of the insurance company, that the amounts paid to them do not constitute dividends. Accordingly, the deduction provided by section 243(a) of the Code (relative to dividends received by corporations) is not allowable to such recipients.

SUBCHAPTER M.—REGULATED INVESTMENT COMPANIES

SECTION 852.—TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS

(Also Part II, Section 362; Regulations 118, Section 39.362–2.) Rev. Rul. 56–246

A multi-fund regulated investment company constitutes one taxpayer for Federal income tax purposes and may not report, as separate entities the segregated gains and losses of its various funds. See *Union Trusteed Funds, Inc.* v. *Commissioner*, 8 T. C. 1133, acquiescence, C. B. 1947–2, 4. Accordingly, in the case of such company, no gain or loss is realized upon the transfer of securities, for an offsetting transfer of cash, directly between one fund and another within the same company, and the basis of such securities for the purpose of determining gain or loss by the company upon their sale remains unchanged. Such company may not designate any dividend, under section 852(b)

(3) (C) of the Internal Revenue Code of 1954 or section 362(b) (7) of the Internal Revenue Code of 1939, as a capital gain dividend where the claimed capital gain is the result of the transfer of securities, for an offsetting transfer of cash, directly between one fund and another within such multi-fund company.

SUBCHAPTER N.—TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

PART I.—DETERMINATION OF SOURCES OF INCOME

SECTION 862.—INCOME FROM SOURCES WITHOUT THE UNITED STATES

Tax of nonresident alien married to a United States citizen domiciled in a community property State and employed by the United States Government outside the United States. See Rev. Rul. 56–269, page 318.

PART II.—NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

SUBPART A.—NONRESIDENT ALIEN INDIVIDUALS

SECTION 871.—TAX ON NONRESIDENT ALIEN INDIVIDUALS

Rev. Rul. 56–268

A domestic foundation was organized primarily to advance the cultural and educational background of employees in a certain field of business by making awards to such employees. The awards are based upon and keyed to the character, ambition, and general merit of the particular individual. One of the purposes of the foundation is to assist promising young men and women to acquire the experience, skills, and self-confidence which lead to positions of higher responsibility. Employees of foreign branches of a domestic corporation participate in the program. The employees are brought to this country to study various aspects of the particular business field. Generally, the awards will also benefit the employer due to the broadened knowledge and increased skills acquired by the employees. During his stay in this country, each employee's salary is paid to his dependents by the foreign branch. *Held*, the salary paid by the employer to the employee, his family or other dependents constitutes compensation for performance of personal services within the United States and is, therefore, subject to United States income tax and the withholding of tax thereon. However, under the provisions of section 861(a) (3) of the 1954 Code, such compensation will not be subject to tax if the employee is temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and such compensation does not exceed $3,000 in the aggregate.

(Also Section 862.) Rev. Rul. 56-269

A nonresident alien wife's share of the community income derived from the performance of personal services by the husband for the United States Government in a foreign country does not lose its identity in her hands as income from sources without the United States and would not be subject to Federal income tax.

Advice has been requested whether a nonresident alien wife's share of the community income from the performance of personal services by the husband for the United States Government in a foreign country is subject to Federal income tax.

The husband, a United States citizen who is domiciled in a community property state, was employed by the Federal Government in a foreign country for the entire taxable year. During the taxable year, he married a nonresident alien who did not at any time during the year reside in the United States.

The question presented is whether the fact that the community income is derived from compensation paid by the United States or an agency thereof and, consequently, is not exempt under the Internal Revenue Code of 1954 (section 911(a)) as to the husband's share, may nevertheless constitute tax exempt income as to the share of the nonresident alien wife.

Under section 871 of the Code, a nonresident alien may be taxed only on income derived from sources within the United States. Section 39.211-2 of Regulations 118, made applicable herein by Treasury Decision 6091, C. B. 1954-2, 47, defines a nonresident alien as one who is not a citizen of the United States and whose residence is not within the United States.

The domicile of a husband in a community property State fixes the domicile of the wife in that State. However, the fact that the wife is domiciled in a community property State does not determine whether she is a nonresident alien. "Domicile" and "residence" are not synonymous for Federal income tax purposes. A citizen of the United States, although domiciled in this country, may under certain circumstances be considered a resident of a foreign country. In ascertaining whether an alien, who is the wife of a citizen or resident of the United States, is, for Federal income tax purposes, a nonresident alien, it is necessary to apply the rules set forth in sections 39.211-1 to 39.211-5 of Regulations 118. Where a husband is domiciled in a community property State, the domicile of the wife is also fixed in that State, and the community income is divisible for Federal income tax purposes. See *Paul Cavanaugh* v. *Commissioner*, 42 B. T. A. 1037, affirmed, 125 Fed. (2d) 366, and *Herbert Marshall* v. *Commissioner*, 41 B. T. A. 1064, acquiescence, C. B. 1947-2, 3. The division of income on the community property basis does not alter the exempt character of the income where it is entitled to exemption under the Code. See Rev. Rul. 55-246, C. B. 1955-1, 92.

Section 862(a)(3) of the Code provides that "the following items of gross income shall be treated as income from sources without the United States: * * * (3) Compensation for labor or personal services performed without the United States."

Section 931 of the Code, dealing with income from sources within possessions of the United States, provides in subsection (i) that "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," but subsection (i) is made applicable only for the purposes of section 931 and not to income from sources within foreign countries.

Section 911(a) of the Code applies to earned income from sources within foreign countries and provides that income coming within its provisions is exempt from taxation "except amounts paid by the United States or any agency thereof." It will be noted that under this section amounts paid by the United States are merely denied the exemption and are not "deemed to be derived from sources within the United States" as in the case of section 931(i).

It is accordingly held that a nonresident alien wife's share of the community income, derived from the performance of personal services by the husband for the United States Government in a foreign country, retains its identity in her hands as income from sources without the United States and is not subject to Federal income tax. If she has no gross income from sources within the United States and is not the dependent of any other taxpayer, the husband may claim an exemption for her on his separate income tax return.

Definition of word "day" for purpose of income tax conventions. See Rev. Rul. 56–24, page 851.

SUBPART C.—MISCELLANEOUS PROVISIONS

SECTION 893.—COMPENSATION OF EMPLOYEES OF FOREIGN GOVERNMENTS OR INTERNATIONAL ORGANIZATIONS

(Also Part II, Section 116; Regulations 118, Section 39.116–2.) Rev. Rul. 56–44

Section 893 of the Internal Revenue Code of 1954 exempts from taxation wages, fees, or salaries of an employee of a foreign government, if such employee is not a citizen of the United States, if the services are of a character similar to those performed by an employee of the United States in foreign countries, and if the foreign government grants an equivalent exemption to employees of the United States in such foreign country. *Held*, the benefits of section 893 of the Code are extended only to any "employee" of a foreign government who qualifies therefor and not to a former employee. Accordingly, a pension received from a foreign government by a former representative of such government, during a period when he is residing in the United States, is not exempt from Federal income tax as wages, fees, or salary received by an employee of a foreign government.

PART III.—INCOME FROM SOURCES WITHOUT THE UNITED STATES

SUBPART A.—FOREIGN TAX CREDIT

SECTION 901.—TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES

Rev. Rul. 56–51

The tax imposed by article 15, chapter IV of Cuban Law No. 7, approved April 5, 1943, as amended by article 25, chapter IV of Cuban Law No. 2, approved May 22, 1951, constitutes an excess profits tax and is, accordingly, allowable as a credit under section 901 of the Internal Revenue Code of 1954.

Rev. Rul. 31, C. B. 1953–1, 225, modified.

The Internal Revenue Service has been requested to reconsider its position, as set forth in Revenue Ruling 31, C. B. 1953–1, 225, in regard to the allowance, as a credit against Federal income tax, of foreign taxes paid pursuant to article 15, chapter IV of Cuban Law No. 7, approved April 5, 1943, as amended by article 25, chapter IV of Cuban Law No. 2, approved May 22, 1951.

The pertinent provisions of chapter IV of Cuban Law No. 7, as amended, read as follows:

ARTICLE 14. A tax of four pesos * * * is hereby levied on each one thousand pesos or fraction thereof, on the capital, estimated at its real worth, with which every partnership or company of any sort or description, whether civil or mercantile, national or foreign, may be operating in Cuba.

ARTICLE 15. Without prejudice to the tax on profits, referred to in the Law of January 29, 1931, and its modifications, which will continue to be paid as heretofore, a tax is established of fifteen per centum (15%) additional on any profits in excess of ten per centum of the capital taxed in the manner specified in the preceding Article.

In Revenue Ruling 31, *supra*, it was held that neither of these taxes constituted an income tax or tax in lieu of an income tax for which a credit could be allowed under section 131 of the Internal Revenue Code of 1939 (section 901 of the Internal Revenue Code of 1954). This conclusion was based on the premise that the levies imposed by articles 14 and 15 were interrelated and interdependent.

Upon reconsideration, it appears that the tax imposed by article 14 of Cuban Law No. 7 of 1943, as amended, is levied against capital valuation and is due whether or not the taxpayer has net income for the period. The tax imposed by article 15 of the Cuban Law, on the other hand, is imposed as an additional tax on the profits subject to taxation and is due only if there is income in the form of profits. Although reference must be made to the valuation of capital declared under article 14, as a basis for computing the excess profits subject to taxation under article 15, this correlation of the two taxes does not cause them to be so integrated that they must be treated as a single tax for the purpose of determining whether credit is allowable for such taxes under section 901 of the Internal Revenue Code of 1954.

It is not intended by any statement made herein to suggest that when a single tax is imposed on items which, by United States standards, are both income and nonincome items, credit is allowable for the portion of the tax imposed on income items but denied for the portion of the tax allocable to nonincome items. When such a unified tax is imposed by a foreign country, its predominant character will determine

whether the tax is an income tax and credit will be denied for the entire amount of the tax or allowed for the entire tax subject to the limitations of section 904 of the Code. I. T. 4074, C. B. 1952–1, 87.

Accordingly, it is held that the two taxes imposed by article 14 and article 15, chapter IV of Cuban Law No. 7 of 1943, as amended, are legally separate and distinct and that the tax imposed by article 15 constitutes a tax on excess profits for which credit is allowed under section 901 of the Code.

Revenue Ruling 31, *supra*, is accordingly modified to the extent that it applies to the tax imposed by article 15, chapter IV of Cuban Law No. 7, approved April 5, 1943, as amended.

(Also Section 902.) Rev. Rul. 56–288

The taxes on dividends imposed by the Australian Income Tax and Social Services Contribution Assessment Act of 1936–1954 constitute income taxes imposed on the shareholder and may be claimed by the shareholder as a credit under the provisions of section 901 of the Code. Furthermore, a domestic corporation owning at least 10 percent of the voting stock of an Australian corporation is entitled to a credit under section 902 of the Code on the basis of a portion of the taxes paid by the Australian subsidiary on income from which such dividends were paid.

(Also Section 902.) Rev. Rul. 56–289

If a domestic corporation, the recipient of dividends from a British corporation, elects to include in its gross income the amount of standard tax appropriate to such dividends paid by the British corporation with respect to such dividends, it is entitled to a credit under section 901 of the Internal Revenue Code of 1954 for the amount of such tax.

Advice has been requested whether a domestic corporation which owned a majority of the stock of a British corporation, including at least 10 percent of the voting stock of such corporation, is entitled to either a deduction under section 164 of the Internal Revenue Code of 1954, or a credit under section 901, for the standard tax appropriate to such dividends paid by the British corporation.

The principal question presented is whether the decision in *Mary D. Biddle et al.* v. *Commissioner*, 302 U. S. 573, Ct. D. 1303, C. B. 1938–1, 309, or article XIII (1) of the income tax convention between the United States and the United Kingdom, Treasury Decision 5569, C. B. 1947–2, 100, is applicable with respect to the standard tax on dividends received by a domestic corporation from a British Corporation.

The Biddle decision determined that the British standard tax paid by a British corporation is laid not upon the shareholder but upon the British corporation. Accordingly, it was held that although the tax burden of the corporation is passed on to its shareholders, the United States statutes do not take that fact into consideration in ascertaining the tax obligation of the shareholder. These statutes do not treat as taxpayers those upon whom no legal duty to pay the tax

is laid. Therefore, on the basis of the Biddle decision, no deduction is allowable to the shareholder under section 23(c)(1)(C) of the Internal Revenue Code of 1939 (now section 164(b)(6) of the Internal Revenue Code of 1954) and no credit is allowable to the shareholder under section 131(a) of the 1939 Code (now section 901(a) of the 1954 Code) for British standard tax paid by corporations.

Under article XIII(1) of the United States–United Kingdom income tax convention, if the shareholder should elect to include in his gross income the amount of the standard tax appropriate to the dividend paid by the British corporation, the shareholder shall be deemed to have paid such tax. Consequently, under the convention, a credit would be allowable to the shareholder under section 901 of the Code for such tax paid. See Rev. Rul. 54–533, C. B. 1954–2, 210. If additional United Kingdom income, war profits, or excess profits taxes not covered by the convention are paid by the British corporation, an additional credit based on such other taxes is allowable to the domestic corporation under section 902, because the domestic corporation owns at least 10 percent of the voting stock of the British corporation.

If the domestic corporation should not elect to treat the standard tax in accordance with article XIII(1) of the convention, the provisions of section 902 would be applicable to both the standard tax and other income, war profits and excess profits taxes paid by the British corporation. Under this section, such taxes would not be included in the shareholder's gross income, but, in accordance with section 902 of the Code, a portion of the taxes paid by the British subsidiary would be deemed to have been paid by the domestic corporation.

Article XIII(1) of the convention with the United Kingdom has no application to the allowance of a deduction to a shareholder for the standard tax paid by a British corporation. Therefore, as held in the Biddle case, the shareholder may not claim a deduction for such tax paid by the corporation.

SECTION 902.—CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION

Credit to a domestic corporation for taxes paid to Australia. See Rev. Rul. 56–288, page 321.

Credit to a domestic corporation for taxes paid to the United Kingdom. See Rev. Rul. 56–289, page 321.

SUBPART C.—WESTERN HEMISPHERE TRADE CORPORATIONS

SECTION 922.—SPECIAL DEDUCTION

Special deduction for Western Hemisphere trade corporations where alternative tax is applicable. See Rev. Rul. 56–151, page 382.

SUBPART D.—POSSESSIONS OF THE UNITED STATES

SECTION 931.—INCOME FROM SOURCES WITHIN POSSESSIONS OF THE UNITED STATES

Rev. Rul. 56–127

United States citizens who are employed in American Samoa by the government thereof are considered to be employees of the "United States or any agency thereof" within the meaning of section 931(i) of the Internal Revenue Code of 1954, and compensation received by such employees for services performed for such government is subject to Federal income tax.

Advice has been requested whether the Government of American Samoa constitutes an agency of the United States within the meaning of section 931(i) of the Internal Revenue Code of 1954.

Section 931(a) of the Internal Revenue Code of 1954 provides that under certain conditions income derived from sources within a possession of the United States by a citizen of the United States or a domestic corporation may be exempt from Federal income tax. However, section 931(i) of the Code provides that amounts received for services performed in a possession of the United States by a citizen of the United States, as an employee of the United States or any agency thereof, are deemed to be derived from sources within the United States. Such amounts, therefore, are subject to Federal income tax.

Following cession of certain islands of the Samoan group to the United States, Executive Order No. 125–A, dated February 19, 1900, placed those islands under the control of the Navy Department. The government which was established in American Samoa by the President of the United States was recognized and accepted by Congress in statutory enactments. See Act of March 4, 1925, 43 Stat. 1357, 48 U. S. C. 1431. With respect to American Samoa in general, the Congressional Act of February 20, 1929, 45 Stat. 1253, 48 U. S. C. 1431a, among other things, stipulated that until Congress should provide for the government of such islands, all civil, judicial, and military powers should be vested in such person or persons and should be exercised in such manner as the President of the United States should direct. The jurisdiction of the Department of the Navy continued over the island group comprising American Samoa until July 1, 1951, when Executive Order No. 125–A was repealed by Executive Order No. 10264, which transferred such jurisdiction to the Department of the Interior. As Congress has not provided a government for American Samoa, the administration and control of the government thereof are still vested in the Department of the Interior.

The term "agency of the United States" is not defined in section 931 of the 1954 Code. However, in certain cases not arising under the Code, the government of a possession of the United States has been held to be an agency of the United States. *Domenech* v. *National City Bank of New York*, 294 U. S. 199; *Bradford* v. *Chase National Bank of City of New York*, 24 Fed. Supp. 28.

It is held that United States citizens who are employed in American Samoa by the government thereof are employees of the "United States or any agency thereof" for the purpose of section 931(i) of the

Internal Revenue Code of 1954. Compensation received by such employees for services performed in American Samoa for the government thereof is, therefore, subject to Federal income tax.

SUBPART E.—CHINA TRADE ACT CORPORATIONS

SECTION 941.—SPECIAL DEDUCTION FOR CHINA TRADE ACT CORPORATIONS

Special deduction where alternative tax is applicable. See Rev. Rul. 56–151, page 382.

SUBCHAPTER O.—GAIN OR LOSS ON DISPOSITION OF PROPERTY

PART II.—BASIS RULES OF GENERAL APPLICATION

SECTION 1014.—BASIS OF PROPERTY ACQUIRED FROM A DECEDENT

Rev. Rul. 56–215

To the extent that property held jointly with the right of survivorship or as tenants by the entirety is includible in a decedent's gross estate as provided by section 2040 of the 1954 Code, section 1014(b)(9) of the 1954 Code provides that, in the hands of the survivor, the basis of that portion of the property includible in the gross estate of a decedent dying after December 31, 1953, shall be fair market value as of the date of valuation for Federal estate tax purposes, as reduced by the amount of depreciation, if any, allowed the taxpayer where the property was acquired prior to the decedent's death. Where the value of the estate is less than $60,000 and, therefore, not subject to the Federal estate tax, the date of death valuation must be used.

The Internal Revenue Service has been requested to state its position with respect to the provisions of section 1014(b)(9) of the Internal Revenue Code of 1954, relating to the basis of property acquired from a decedent dying after December 31, 1953, by the survivor of jointly held property, for purposes of determining gain or loss.

Section 1014 of the Internal Revenue Code of 1954 relating to basis of property acquired from a decedent provides in part as follows:

(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:

* * * * * * *

(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 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 the subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. * * *

Paragraphs (1) to (8), inclusive, of section 1014(b) of the 1954 Code correspond to the provisions of section 113(a)(5) of the 1939 Code and set forth the circumstances under which property is treated as having been acquired from or having passed from the decedent.

The effect of section 1014(b)(9) of the 1954 Code is to make the general rule as provided in subparagraph (a) applicable to practically all property includible in the decedent's gross estate for estate tax purposes. See Report of Committee on Finance, United States Senate No. 1622, 83d Congress, page 108.

The rule set forth in paragraph (9), subsection (b), section 1014 of the Code applies to that portion of jointly held property includible in the decedent's gross estate under the provisions of section 2040 of the Internal Revenue Code of 1954. The fact that no estate tax may be due or that no estate tax return is required does not preclude the application of section 1014(b)(9) of the Code, if the property is otherwise required to be included in determining the decedent's gross estate for Federal estate tax purposes. However, no alternate valuation may be elected for property where the value of the estate does not exceed $60,000 at the time of the decedent's death. See Rev. Rul. 56-60, page 443 of this Bulletin.

Rev. Rul. 56-270

The decedent bequeathed in trust for the benefit of his wife an amount sufficient to utilize the marital deduction to the maximum extent authorized by section 2056 of the Internal Revenue Code of 1954 after taking into consideration any other property with respect to which such deduction is allowable. The income from the trust is given to the surviving spouse for life with a power exercisable by her alone at death to appoint the entire interest to any other person or persons, or to her estate. *Held*, the marital trust fund was provided for in a fixed and definite "dollar amount." Accordingly, capital gains were realized by the estate to the extent that the fair market value of the property on the date of distribution to the trustee exceeds the fair market value thereof on the date of the decedent's death (or, in the event alternate valuation is elected, the fair market value thereof on the alternate valuation date). See *William R. Kenan, Jr., et al.* v *Commissioner*, 114 Fed. (2d) 217, and *Sarah P. Suisman* v. *Eaton*, 15 Fed. Supp. 113, affirmed, 83 Fed. (2d) 1019, certiorari denied, 299 U. S. 573. Consistent with the foregoing conclusion, it is further held that losses measured by the difference between the basis of the property in the hands of the executor and the value thereof at the date of distribution to the marital trust may be offset against the gains realized.

SECTION 1017.—DISCHARGE OF INDEBTEDNESS

26 CFR 1.1017–1: Adjusted basis; discharge of indebtedness; general rule.

Regulations under the 1954 Code relating to adjustment to the basis of property in certain cases involving the discharge of indebtedness. See T. D. 6158, page 81.

PART III.—COMMON NONTAXABLE EXCHANGES

SECTION 1034.—SALE OR EXCHANGE OF RESIDENCE

26 CFR 1.1034: Statutory provisions; common nontaxable exchanges; sale or exchange of residence. T. D. 6179[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Regulations under section 1034 of the Internal Revenue Code of 1954

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

AUTHORITY: §§ 1.1034 and 1.1034–1 issued under sections 1034, 7805, I. R. C. 1954; 68A Stat. 306, 917; 26 U. S. C. 1034, 7805.

On July 28, 1955, notice of proposed rulemaking regarding regulations under section 1034 of the Internal Revenue Code of 1954, was published in the Federal Register (20 F. R. 5393). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the following regulations are hereby adopted:

§ 1.1034 STATUTORY PROVISIONS; COMMON NONTAXABLE EXCHANGES; SALE OR EXCHANGE OF RESIDENCE.

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.

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[1] 21 F. R. 3778.

(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.

§ 1.1034–1 SALE OR EXCHANGE OF RESIDENCE—(a) *Nonrecognition of gain; general statement.*—Section 1034 provides rules for the nonrecognition of gain in certain cases where a taxpayer sells one residence after December 31, 1953, and buys or builds, and uses as his principal residence, another residence within specified time limits before or after such sale. In general, if the taxpayer invests in a new residence an amount at least as large as the adjusted sales price of his old residence, no gain is recognized on the sale of the old residence (see paragraph (b) of this section for definition of "adjusted sales price", "new residence", and "old residence"). On the other hand, if the new residence costs the taxpayer less than the adjusted sales price of the old residence, gain is recognized to the extent of the difference. Thus, if an amount equal to or greater than the adjusted sales price of an old residence is invested in a new residence, according to the rules stated in section 1034, none of the gain (if any) realized from the sale shall be recognized. If an amount less than such adjusted sales price is so invested, gain shall be recognized, but only to the extent provided in section 1034. If there is no investment in a new residence, section 1034 is inapplicable and all of the gain shall be recognized. Whenever, as a result of the application of section 1034, any or all of the gain realized on the sale of an old residence is not recognized, a corresponding reduction must be made in the basis of the new residence. The provisions of section 1034 are mandatory, so that the taxpayer cannot elect to have gain recognized under circumstances where this section is applicable. Section 1034 applies only to gains; losses are recognized or not recognized without regard to the provisions of this section. Section 1034 affects only the amount of gain recognized, and not the amount of gain realized (see also section 1001 and regulations issued thereunder). Any gain realized upon disposition of other property in exchange for the new residence is not affected by section 1034.

(b) *Definitions.*—The following definitions of frequently used terms are applicable for purposes of section 1034 (other definitions and detailed explanations appear in subsequent paragraphs of this regulation):

(1) "Old residence" means property used by the taxpayer as his principal residence which is the subject of a sale by him after December 31, 1953 (section 1034(a); for detailed explanation see § 1.1034–1(c)(3)).

(2) "New residence" means property used by the taxpayer as his principal residence which is the subject of a purchase by him (section 1034(a); for detailed explanation and limitations see § 1.1034–1(c)(3) and (d)(1)).

(3) "Adjusted sales price" means the amount realized reduced by the fixing-up expenses (section 1034(b)(1); for special rule applicable in some cases to husband and wife see § 1.1034–1(f)).

(4) "Amount realized" is to be computed by subtracting

(i) The amount of the items which, in determining the gain from the sale of the old residence, are properly an offset against the considerations received upon the sale (such as commissions and expenses of advertising the property for sale, of preparing the deed, and of other legal services in connection with the sale); from

(ii) The amount of the consideration so received, determined (in accordance with section 1001(b) and regulations issued thereunder) by adding to the sum of any money so received, the fair market value of the property (other than money) so received. If, as part of the consideration for the sale, the purchaser either assumes a liability of the taxpayer or acquires the old residence subject to a liability (whether or not the taxpayer is personally liable on the debt), such assumption or acquisition, in the amount of the liability, shall be treated as money received by the taxpayer in computing the "amount realized."

(5) "Gain realized" is the excess (if any) of the amount realized over the adjusted basis of the old residence (see also section 1001(a) and regulations issued thereunder).

(6) "Fixing-up expenses" means the aggregate of the expenses for work performed (in any taxable year, whether beginning before, on, or after January 1, 1954) on the old residence in order to assist in its sale, provided that such expenses (i) are incurred for work performed during the 90-day period ending on the day on which the contract to sell the old residence is entered into; and (ii) are paid on or before the 30th day after the date of the sale of the old residence; and (iii) are neither (*a*) allowable as deductions in computing taxable income under section 63(a), nor (*b*) taken into account in computing the amount realized from the sale of the old residence (section 1034(b)(2) and (3)). "Fixing-up expenses" does not include expenditures which are properly chargeable to capital account and which would, therefore, constitute adjustments to the basis of the old residence (see section 1016 and regulations issued thereunder).

(7) "Cost of purchasing the new residence" means the total of all amounts which are attributable to the acquisition, construction, reconstruction, and improvements constituting capital expenditures, made during the period beginning one year before the date of sale of the old residence and ending either (i) one year after such date in the case of a new residence purchased but not constructed by the taxpayer, or (ii) 18 months after such date in the case of a new residence the construction of which was commenced by the taxpayer before the expiration of one year after such date (section 1034(a), (c)(2) and (c)(5); for detailed explanation see § 1.1034–1(c)(4); for special rule applicable in some cases to husband and wife see § 1.1034–1(f); see also § 1.1034–1(b)(9) for definition of "purchase").

(8) "Sale" (of a residence) means a sale or an exchange (of a residence) for other property either of which occurs after December 31, 1953, or an involuntary conversion (of a residence) which occurs after December 31, 1950, and before January 1, 1954 (section 1034(c)(1) and (i)(1)(A)); for detailed explanation concerning involuntary conversion see § 1.1034–1(h).

(9) "Purchase" (of a residence) means a purchase or an acquisition (of a residence) on the exchange of property or the partial or total construction or reconstruction (of a residence) by the taxpayer (section 1034(c)(1) and (2)). However, the mere improvement of a residence, not amounting to reconstruction, does not constitute "purchase" of a residence.

(c) *Rules for application of section 1034.*—(*1*) *General rule; limitations on applicability.*—Gain realized from the sale (after December 31, 1953) of an old residence will be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence, provided that the taxpayer either (i) within a period beginning one year before the date of such sale and ending one year after such date purchases property and uses it as his principal residence, or (ii) within a period beginning one year before the date of such sale and ending 18 months after such date uses as his principal residence a new residence the construction of which was commenced by him at any time before the expiration of one year after the date of the sale of the old residence (section 1034(a) and (c)(5); for detailed explanation of use as "principal residence" see § 1.1034–1(c)(3)). The rule stated in the preceding sentence applies to a new residence purchased by the taxpayer before the date of sale of the old residence provided the new residence is still owned by him on such date (section 1034(c)(3)). Whether the construction of a new residence was commenced by the taxpayer before the expiration of one year after the date of the sale of the old residence will depend upon the facts and circumstances of each case. Section 1034 is not applicable to the sale of a residence if within the previous year the taxpayer made another sale of residential property on which gain was realized but not recognized (section 1034(d)). For further details concerning limitations on the application of section 1034, see § 1.1034–1(d).

(2) *Computation and examples.*—In applying the general rule stated in subparagraph (1) of this paragraph, the taxpayer should first subtract the commissions and other selling expenses from the selling price of his old residence, to determine the amount realized. A comparison of the amount realized with the cost or other basis of the old residence will then indicate whether there is any gain realized on the sale. Unless the amount realized is greater than the cost or other basis, no gain is realized and section 1034 does not apply. If the amount realized exceeds the cost or other basis, the amount of such excess constitutes the gain realized. The amount realized should then be reduced by the fixing-up expenses (if any), to determine the adjusted sales price. A comparison of the adjusted sales price of the old residence with the cost of purchasing the new residence will indicate how much (if any) of the realized gain is to be recognized. If the cost of purchasing the new residence is the same as, or greater

than, the adjusted sales price of the old residence, then none of the realized gain is to be recognized. On the other hand, if the cost of purchasing the new residence is smaller than the adjusted sales price of the old residence, the gain realized is to be recognized to the extent of the difference. (It should be noted that any amount of gain realized but not recognized is to be applied as a downward adjustment to the basis of the new residence (for details see § 1.1034–1(e)).) The application of the general rule stated above may be illustrated by the following examples:

Example (1). A taxpayer decides to sell his residence, which has a basis of $17,500. To make it more attractive to buyers, he paints the outside at a cost of $300 in April 1954. He pays for the painting when the work is finished. In May 1954, he sells the house for $20,000. Brokers' commissions and other selling expenses are $1,000. In October 1954, the taxpayer buys a new residence for $18,000. The amount realized, the gain realized, the adjusted sales price, and the gain to be recognized are computed as follows:

Selling price	$20,000	
Less: Commissions and other selling expenses	1,000	
Amount realized	$19,000	
Less: Basis	17,500	
Gain realized		$1,500
Amount realized	$19,000	
Less: Fixing-up expenses	300	
Adjusted sales price	$18,700	
Cost of purchasing new residence	18,000	
Gain recognized		$700
Gain realized but not recognized		$800
Adjusted basis of new residence (see § 1.1034–1(e))	$17,200	

Example (2). The facts are the same as in example (1), except that the selling price of the old residence is $18,500. The computations are as follows:

Selling price	$18,500	
Less: Commissions and other selling expenses	1,000	
Amount realized	$17,500	
Less: Basis	17,500	
Gain realized		$ 0

(NOTE: Since no gain is realized, section 1034 is inapplicable; it is, therefore, unnecessary to compute the adjusted sales price of the old residence and compare it with the cost or purchasing the new residence. No adjustment to the basis of the new residence is to be made.)

Example (3). The facts are the same as in example (1), except that the cost of purchasing the new residence is $17,000. The computations are as follows:

Selling price	$20,000	
Less: Commissions and other selling expenses	1,000	
Amount realized	$19,000	
Less: Basis	17,500	
Gain realized		$1,500
Amount realized	$19,000	
Less: Fixing-up expenses	300	
Adjusted sales price	$18,700	
Cost of purchasing the new residence	17,000	
Gain recognized		$1,500

(NOTE: Since the adjusted sales price of the old residence exceeds the cost of purchasing the new residence by $1,700, which is more than the gain realized, all of the gain realized is recognized. No adjustment to the basis of the new residence is to be made.)

Gain realized but not recognized	$ 0

Example (4). The facts are the same as in example (1), except that the fixing-up expenses are $1,100. The computations are as follows:

Selling price	$20,000	
Less: Commissions and other selling expenses	1,000	
Amount realized	$19,000	
Less: Basis	17,500	
Gain realized		$1,500
Amount realized	$19,000	
Less: Fixing-up expenses	1,100	
Adjusted sales price	$17,900	
Cost of purchasing the new residence	18,000	
Gain recognized		$ 0

(NOTE: Since the cost of purchasing the new residence exceeds the adjusted sales price, none of the gain realized is recognized.)

Gain realized but not recognized	$1,500
Adjusted basis of new residence (see § 1.1034-1(e))	$16,500

(3) *Property used by the taxpayer as his principal residence.*— (i) Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. The mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he temporarily rents out the new residence during the period before he vacates the old residence may not, in the light of all the facts and circumstances in the case, pre-

vent the new residence from being considered as property used by the taxpayer as his principal residence. Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)), if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his principal residence (section 1034(f)). Property used by the taxpayer as his principal residence does not include personal property such as a piece of furniture, a radio, etc., which, in accordance with the applicable local law, is not a fixture.

(ii) Where part of a property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this section. If the old residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under this section and only an amount allocable to the selling price of such portion need be invested in the new residence in order to have the gain allocable to such portion not recognized under this section. If the new residence is used only partially for residential purposes only so much of its cost as is allocable to the residential portion may be counted as the cost of purchasing the new residence.

(4) *Cost of purchasing new residence.*—(i) The taxpayer's cost of purchasing the new residence includes not only cash but also any indebtedness to which the property purchased is subject at the time of purchase whether or not assumed by the taxpayer (including purchase-money mortgages, etc.) and the face amount of any liabilities of the taxpayer which are part of the consideration for the purchase. Commissions and other purchasing expenses paid or incurred by the taxpayer on the purchase of the new residence are to be included in determining such cost. In the case of an acquisition of a residence upon an exchange which is considered as a "purchase" under this section, the fair market value of the new residence on the date of the exchange shall be considered as the taxpayer's cost of purchasing the new residence. Where any part of the new residence is acquired by the taxpayer other than by "purchase", the value of such part is not to be included in determining the taxpayer's cost of the new residence (see § 1.1034–1 (b) (9) for definition of "purchase"). For example, if the taxpayer acquires a residence by gift or inheritance, and spends $20,000 in reconstructing such residence, only such $20,000 may be treated as his cost of purchasing the new residence.

(ii) The taxpayer's cost of purchasing the new residence includes only so much of such cost as is attributable to acquisition, construction, reconstruction, or improvements made within the 2-year or 30-month period of time, as the case may be, in which the purchase and use of the new residence must be made in order to have gain on the sale of the old residence not recognized under this section. Thus, if the construction of the new residence is begun two years before the date of sale of the old residence and completed on the date of sale of the old residence, only that portion of the cost which is attributable to the second year of such construction constitutes the taxpayer's cost of purchasing the new residence, for purposes of section 1034. Furthermore, the taxpayer's cost of purchasing the new residence includes

only such amounts as are properly chargeable to capital account rather than to current expense. As to what constitutes capital expenditures, see section 263.

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example. M began the construction of a new residence on January 15, 1955, and completed it on October 14, 1955. The cost of $18,000 was incurred ratably over the 9-month period of construction. On July 14, 1956, M sold his old residence and realized a gain of $7,200. In determining the extent to which the realized gain is not to be recognized under section 1034, M's cost of constructing the new residence shall include only the $6,000 which was attributable to the July 15–October 14, 1955, period (3 months at $2,000). The $12,000 balance of the cost of constructing the new residence was not attributable to the period beginning one year before the date of sale of the old residence and ending 18 months after such date and, under section 1034, is not properly a part of M's cost of constructing the new residence.

(d) *Limitations on application of section 1034.*—(1) If a residence is purchased by the taxpayer prior to the date of the sale of the old residence, the purchased residence shall, in no event, be treated as a new residence if such purchased residence is sold or otherwise disposed of by him prior to the date of the sale of the old residence (section 1034(c)(3)). And, if the taxpayer, during the period within which the purchase and use of the new residence must be made in order to have any gain on the sale of the old residence not recognized under this section, purchases more than one property which is used by him as his principal residence during the one year (or 18 months in the case of the construction of the new residence) succeeding the date of the sale of the old residence, only the last of such properties shall be considered a new residence (section 1034(c)(4)). If within one year before the date of the sale of the old residence, the taxpayer sold other property used by him as his principal residence at a gain, and any part of such gain was not recognized under this section or section 112 (n) of the Internal Revenue Code of 1939, this section shall not apply with respect to the sale of the old residence (section 1034(d)).

(2) The following example will illustrate the rules of subparagraph (1):

Example. A taxpayer sells his old residence on January 15, 1954, and purchases another residence on February 15, 1954. On March 15, 1954, he sells the residence which he bought on February 15, 1954, and purchases another residence on April 15, 1954. The gain on the sale of the old residence on January 15, 1954, will not be recognized except to the extent to which the taxpayer's adjusted sales price of the old residence exceeds the cost of purchasing the residence which he purchased on April 15, 1954. Gain on the sale of the residence which was bought on February 15, 1954, and sold on March 15, 1954, will be recognized.

(e) *Basis of new residence.*—(1) Where the purchase of a new residence results, under this section, in the nonrecognition of any part of

the gain realized upon the sale of an old residence, then, 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 which was not recognized upon the sale of the old residence (section 1034(e); for special rule applicable in some cases to husband and wife, see § 1.1034–1(f)). Such a reduction is not to be made for the purpose of determining the adjusted basis of the new residence as of any time preceding the sale of the old residence. For the purpose of this determination, the amount of the gain not recognized under this section upon the sale of the old residence includes only so much of the gain as is not recognized because of the taxpayer's cost, up to the date of the determination of the adjusted basis, of purchasing the new residence.

(2) The following example will illustrate the rule of subparagraph (1):

Example. On January 1, 1954, the taxpayer buys a new residence for $10,000. On March 1, 1954, he sells for an adjusted sales price of $15,000 his old residence, which has an adjusted basis to him of $5,000 (no fixing-up expenses are involved, so that $15,000 is the "amount realized" as well as the "adjusted sales price"). Between April 1 and April 15 a wing is constructed on the new house at a cost of $5,000. Between May 1 and May 15 a garage is constructed at a cost of $2,000. The adjusted basis of the new residence is $10,000 during January and February, $5,000 during March, $5,000 following the completion of the construction in April, and $7,000 following the completion of the construction in May. Since the old residence was not sold until March 1, no adjustment to the basis of the new residence is made during January and February. Computations for March, April, and May are as follows:

Amount realized on sale of old residence	$15,000	
Less: Adjusted basis of old residence	5,000	
Gain realized on sale of old residence		$10,000
March 1, 1954		
Adjusted sales price of old residence	$15,000	
Less: Cost of purchasing new residence	10,000	
Gain recognized		$5,000
Gain realized but not recognized		5,000
Cost of purchasing new residence	$10,000	
Less: Gain realized but not recognized	5,000	
Adjusted basis of new residence	$5,000	
April 15, 1954		
Gain realized on sale of old residence		$10,000
Adjusted sales price of old residence	$15,000	
Less: Cost of purchasing new residence	15,000	
Gain recognized		0
Gain realized but not recognized		$10,000

Cost of purchasing new residence	$15,000	
Less: Gain realized but not recognized	10,000	
Adjusted basis of new residence	$5,000	

May 15, 1954

Gain realized on sale of old residence		$10,000
Adjusted sales price of old residence	$15,000	
Less: Cost of purchasing new residence	17,000	
Gain recognized		0
Gain realized but not recognized		$10,000
Cost of purchasing new residence	$17,000	
Less: Gain realized but not recognized	10,000	
Adjusted basis of new residence	$7,000	

(f) *Husband and wife.*—(1) If the taxpayer and his spouse file the consent referred to in this paragraph, then the "taxpayer's adjusted sales price of the old residence" shall mean the taxpayer's, or the taxpayer's and his spouse's, adjusted sales price of the old residence, and the "taxpayer's cost of purchasing the new residence" shall mean the cost to the taxpayer, or to his spouse, or to both of them, of purchasing the new residence, whether such new residence is held by the taxpayer, or his spouse, or both (section 1034(g)). Such consent may be filed only if the old residence and the new residence are each used by the taxpayer and his same spouse as their principal residence. If the taxpayer and his spouse do not file such a consent, the recognition of gain upon sale of the old residence shall be determined under this section without regard to the foregoing.

(2) The consent referred to in subparagraph (1) of this paragraph is a consent by the taxpayer and his spouse to have the basis of the interest of either of them in the new residence reduced from what it would have been but for the filing of such consent by an amount by which the gain of either of them on the sale of his interest in the old residence is not recognized solely by reason of the filing of such consent. Such reduction in basis is applicable to the basis of the new residence, whether such basis is that of the husband, of the wife, or divided between them. If the basis is divided between the husband and wife, the reduction in basis shall be divided between them in the same proportion as the basis (determined without regard to such reduction) is divided. Such consent shall be filed with the district director with whom the taxpayer filed the return for the taxable year or years in which the gain from the sale of the old residence was realized.

(3) The following examples will illustrate the application of this rule:

Example (1). A taxpayer, in 1954, sells for an adjusted sales price of $10,000 the principal residence of himself and his wife, which he owns individually and which has an adjusted basis to him of $5,000 (no fixing-up expenses are involved, so that $10,000 is the "amount realized" as well as the "adjusted sales price"). Within a year after such sale he and his wife contribute $5,000 each from their separate funds for the purchase of their new

principal residence which they hold as tenants in common, each owning an undivided one-half interest therein. If the taxpayer and his wife file the required consent, the gain of $5,000 upon the sale of the old residence will not be recognized to the taxpayer, and the adjusted basis of the taxpayer's interest in the new residence will be $2,500 and the adjusted basis of his wife's interest in such property will be $2,500.

Example (2). A taxpayer and his wife, in 1954, sell for an adjusted sales price of $10,000 their principal residence, which they own as joint tenants and which has an adjusted basis of $2,500 to each of them ($5,000 together) (no fixing-up expenses are involved, so that $10,000 is the "amount realized" as well as the "adjusted sales price"). Within a year after such sale, the wife spends $10,000 of her own funds in the purchase of a principal residence for herself and the taxpayer and takes title in her name only. If the taxpayer and his wife file the required consent, the adjusted basis to the wife of the new residence will be $5,000, and the gain of the taxpayer of $2,500 upon the sale of the old residence will not be recognized. The wife, as a taxpayer herself, will have her gain of $2,500 on the sale of the old residence not recognized under the general rule.

(g) *Members of Armed Forces.*—(1) Section 1034(h) provides a special rule for members of the Armed Forces with respect to the period after the sale of the old residence within which the acquisition of a new residence may result in a nonrecognition of gain on such sale. The running of the 1-year period after the sale of the old residence in the case of the purchase of a new residence, or the 18-month period after such sale in the case of the construction of a new residence, is suspended during any time that the taxpayer serves on extended active duty with the Armed Forces of the United States during an induction period (as defined in section 112(c)(5)). However, in no event may such suspension extend for more than four years after the date of the sale of the old residence the period within which the purchase or construction of a new residence may result in a nonrecognition of gain. For example, if the taxpayer is on extended active duty with the army from January 1, 1951, to December 31, 1953, and if he sold his old residence on January 1, 1951, the latest date on which the taxpayer may use a new residence constructed by him and have any part of the gain on the sale of the old residence not recognized under this section is January 1, 1955, the date four years after the date of sale of the old residence.

(2) This suspension covers not only the Armed Forces services of the taxpayer but if the taxpayer and his same spouse used both the old and the new residences as their principal residence, then the extension applies in like manner to the time the taxpayer's spouse is on extended active duty with the Armed Forces of the United States.

(3) The time during which the running of the period is suspended is part of such period. Thus, construction costs during such time are includible in the cost of purchasing the new residence under paragraph (c)(4) of this section.

(4) The running of the 1-year (or 18-month) period after the date of sale of the old residence referred to in section 1034(c)(4) and in paragraph (d) of this section is not suspended; neither is the running

of the 1-year period prior to the date of the sale of the old residence within which the new residence may be purchased in order to have gain on the sale of the old residence not recognized under this section.

(5) The term "extended active duty" means any period of active duty which is served pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. If the call or order is for a period of more than 90 days, it is immaterial that the time served pursuant to such call or order is less than 90 days, if the reason for such shorter period of service occurs after the beginning of such duty. As to what constitutes active service as a member of the Armed Forces of the United States, see § 1.112–1(i). As to who are members of the Armed Forces of the United States, see section 7701(a)(15) and the regulations thereunder.

(h) *Special rule for involuntary conversions.*—Section 1034 is inapplicable to involuntary conversions of personal residences occurring after December 31, 1953 (section 1034(i)(1)(B)). However, for purposes of section 1034, an involuntary conversion of a personal residence occurring after December 31, 1950, and before January 1, 1954, is treated as a sale of such residence (section 1034(i)(1)(A); see § 1.1034–1(b)(8)). For the purposes of this section an involuntary conversion is defined as the destruction in whole or in part, theft, seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof. See section 1033 for treatment of residences involuntarily converted after December 31, 1953.

(i) *Statute of limitations.*—(1) Whenever a taxpayer sells property used as his principal residence at a gain, the statutory period prescribed in section 6501(a) for the assessment of a deficiency attributable to any part of such gain shall not expire prior to the expiration of three years from the date of receipt, by the district director with whom the return was filed for the taxable year or years in which the gain from the sale of the old residence was realized (section 1034(j)), of a written notice from the taxpayer of—

(i) The taxpayer's cost of purchasing the new residence which the taxpayer claims results in nonrecognition of any part of such gain,

(ii) The taxpayer's intention not to purchase a new residence within the period when such a purchase will result in nonrecognition of any part of such gain, or

(iii) The taxpayer's failure to make such a purchase within such period.

Any gain from the sale of the old residence which is required to be recognized shall be included in gross income for the taxable year or years in which such gain was realized. Any deficiency attributable to any portion of such gain may be assessed before the expiration of the 3-year period described in this paragraph, notwithstanding the provisions of any law or rule of law which might otherwise bar such assessment.

(2) The notification required by the preceding subparagraph shall contain all pertinent details in connection with the sale of the old residence and, where applicable, the purchase price of the new residence. The notification shall be in the form of a written statement and shall be accompanied, where appropriate, by an amended return for the year

in which the gain from the sale of the old residence was realized, in order to reflect the inclusion in gross income for that year of gain required to be recognized in connection with such sale.

(j) *Effective date.*—Pursuant to section 7851(a)(1)(C), paragraphs (a), (b), (c), (d), (f), (g), and (i) of this section apply in the case of any "sale" (as defined in subparagraph (8) of paragraph (b)) made after December 31, 1953, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939. Similarly, the rule in paragraph (h) that involuntary conversions of personal residences are not to be treated as sales for purposes of section 1034 but are governed by section 1033 applies to any such involuntary conversion made after December 31, 1953, although such involuntary conversion may occur in a taxable year subject to the Internal Revenue Code of 1939. The rule in paragraph (e) requiring an adjustment to the basis of a new residence, the purchase of which results (under section 1034, or section 112(n) of the Internal Revenue Code of 1939) in the nonrecognition of gain on the sale of an old residence, applies in determining the adjusted basis of the new residence at any time following such sale, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939.

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved May 29, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Filed by the Division of the Federal Register June 1, 1956, 8:52 a. m.)

PART IV.—SPECIAL RULES

SECTION 1051.—PROPERTY ACQUIRED DURING AFFILIATION

26 CFR 1.1051-1: Statutory provisions: Property acquired during affiliation. T. D. 6178[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Regulations prescribed under parts IV, V, VI, and VII of subchapter 0 of chapter 1 of the Internal Revenue Code of 1954.

DEPARTMENT OF THE TREASURY,
OFFICE OF THE COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On December 1, 1955, notice of proposed rulemaking regarding the regulations for taxable years beginning after December 31, 1953, and ending after August 16, 1954, under parts IV, V, VI, and VII of subchapter 0 of chapter 1 (relating to gain or loss on disposition of prop-

[1] 21 F. R. 3782.

erty) of the Internal Revenue Code of 1954, was published in the Federal Register (20 F. R. 8816). After consideration of all such relevant matter as was presented by interested parties regarding the rules proposed, the following regulations are hereby adopted:

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AUTHORITY: §§ 1.1051 to 1.1091–2, incl., issued under secs. 1051, 1071, 1081, 1082, 1091, 7805, I. R. C. 1954; 68A Stat. 310, 311, 312, 315, 319, 917; 26 U. S. C. 1051, 1071, 1081, 1082, 1091, 7805.

SPECIAL RULES

§ 1.1051 STATUTORY PROVISIONS; PROPERTY ACQUIRED DURING AFFILIATION.

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.

§ 1.1051–1 BASIS OF PROPERTY ACQUIRED DURING AFFILIATION.—(a) (1) The basis of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated shall be the same as it would be in the hands of the corporation from which acquired. This rule is applicable if the basis of the property is material in determining tax liability for any year, whether a separate return or a consolidated return is made in respect of such year. For the purpose 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.

(2) The application of subparagraph (1) above may be illustrated by the following example:

Example. The X Corporation, the Y Corporation, and the Z Corporation were affiliated for the taxable year 1920. During that year the X Corporation transferred assets to the Y Corporation for $120,000 cash, and the Y Corporation in turn transferred the assets during the same year to the Z Corporation for $130,000 cash. The assets were acquired by the X Corporation in 1916 at a cost of $100,000. The basis of the assets in the hands of the Z Corporation is $100,000.

(b) The basis 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 or was required under

the regulations governing the making of consolidated returns, shall be determined in accordance with such regulations. 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 is made or is required under the regulations governing the making of consolidated returns, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

(c) Except as otherwise provided in the regulations promulgated under section 1502, or the regulations under section 141 of the Internal Revenue Code of 1939 or the Revenue Acts of 1938, 1936, 1934, 1932, or 1928, the basis of property after a consolidated return period shall be the same as the basis immediately prior to the close of such period.

§ 1.1052 Statutory Provisions; Basis Established by the Revenue Act of 1932 or 1934 or by the Internal Revenue Code of 1939.

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.

§ 1.1052–1 Basis of Property Established by Revenue Act of 1932. Section 1052 (a) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932, was prescribed by section 113(a) (6), (7), or (9) of that Act, then for purposes of subtitle A the basis shall be the same as the basis prescribed in the Revenue Act of 1932. For the rules applicable in determining the basis of stocks or securities under section 113(a) (9) of the Revenue Act of 1932 in case of certain distributions after December 31, 1923, and in any taxable year beginning before January 1, 1934, see § 39.113(a) (12)–1 of Regulations 118.

§ 1.1052–2 Basis of Property Established by Revenue Act of 1934.—Section 1052(b) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1936, and the basis of the property for the purposes of the Revenue Act of 1934 was prescribed by section 113(a) (6), (7), or (8) of that Act, then for purposes of subtitle A the basis shall be the same as the basis prescribed in the Revenue Act of 1934. For example, if after December 31, 1920, and in any taxable year beginning before

January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112(b)(5) of the Internal Revenue Code of 1939 but which is described in section 112(b)(5) of the Revenue Act of 1934, the basis of the property so acquired shall be the same as it would be in the hands of the transferor, with proper adjustments to the date of the exchange.

§ 1.1052–3 Basis of Property Established by the Internal Revenue Code of 1939.—Section 1052(c) provides that if property was acquired after February 28, 1913, in a transaction to which the Internal Revenue Code of 1939 applied and the basis thereof was prescribed by section 113(a) (6), (7), (8), (13), (15), (18), (19) or (23) of such code, then for purposes of subtitle A the basis shall be the same as the basis prescribed in the Internal Revenue Code of 1939. In such cases see section 113(a) of the Internal Revenue Code of 1939 and the regulations thereunder.

§ 1.1053. Statutory Provisions; Basis of Property Acquired Before March 1, 1913.

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.

§ 1.1053–1 Property Acquired Before March 1, 1913.—(a) *Basis for determining gain.*—In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining gain is the cost or other basis, adjusted as provided in section 1016 and other applicable provisions of chapter 1, or its fair market value as of March 1, 1913, whichever is greater.

(b) *Basis for determining loss.*—In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining loss is the basis determined in accordance with part II of subchapter O, or other applicable provisions of chapter 1, without reference to the fair market value as of March 1, 1913.

(c) *Example.*—The application of paragraphs (a) and (b) above may be illustrated by the following example:

Example.—(i) On March 1, 1908, a taxpayer purchased for $100,000, property having a useful life of 50 years. Assuming that there were no capital improvements to the property, the depreciation sustained on the property before March 1, 1913, was $10,000 (5 years @ $2,000), so that the original cost adjusted, as of March 1, 1913, for depreciation sustained prior to that date is $90,000. On that date the property had a fair market value of $94,500 with a remaining life of 45 years.

(ii) For the purpose of determining gain from the sale or other disposition of the property on March 1, 1954, the basis of the property is the fair market value of $94,500 as of March 1, 1913, adjusted for depreciation allowed or allowable after Feb-

ruary 28, 1913, computed on $94,500. Thus, the substituted basis, $94,500, is reduced by the depreciation adjustment from March 1, 1913, to February 28, 1954, in the aggregate of $86,100 (41 years @ $2,100), leaving an adjusted basis for determining gain of $8,400 ($94,500 less $86,100).

(iii) For the purpose of determining loss from the sale or other disposition of such property on March 1, 1954, the basis of the property is its cost, adjusted for depreciation sustained before March 1, 1913, computed on cost, and the amount of depreciation allowed or allowable after February 28, 1913, computed on the fair market value of $94,500 as of March 1, 1913. In this example, the amount of depreciation sustained before March 1, 1913, is $10,000 and the amount of depreciation determined for the period after February 28, 1913, is $86,100. Therefore, the aggregate amount of depreciation for which the cost ($100,000) should be adjusted is $96,100 ($10,000 plus $86,100), and the adjusted basis for determining loss on March 1, 1954, is $3,900 ($100,000 less $96,100).

(d) *Fair market value.*—The determination of the fair market value of property on March 1, 1913, is generally a question of fact and shall be established by competent evidence. In determining the fair market value of stock or other securities, due regard shall be given to the fair market value of the corporate assets as of such date, and other pertinent factors. In the case of property traded in on public exchanges, actual sales on or near the basic date afford evidence of value. In general, the fair market value of a block or aggregate of a particular kind of property is not to be determined by a forced-sale price, or by an estimate of what a whole block or aggregate would bring if placed upon the market at one and the same time. In such a case the value should be determined by ascertaining as the basis the fair market value of each unit of the property. All relevant facts and elements of value as of the basic date should be considered in each case.

§ 1.1054 Statutory Provisions; Cross References.

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).

CHANGES TO EFFECTUATE F. C. C. POLICY

§ 1.1071 Statutory Provisions; Gain From Sale or Exchange to Effectuate Policies of Federal Communications Commission.

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 effectu-

ate 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).

§ 1.1071–1 GAIN FROM SALE OR EXCHANGE TO EFFECTUATE POLICIES OF FEDERAL COMMUNICATIONS COMMISSION.—(a) At the election of the taxpayer, section 1071 in effect postpones the recognition of gain upon the sale or exchange of property, if the Federal Communications Commission certifies such sale or exchange to be necessary or appropriate to effectuate the policies of the Commission with respect to the ownership and control of radio broadcasting stations. Any taxpayer desiring to obtain the benefits of section 1071 shall file with the Commissioner of Internal Revenue, or the district director of internal revenue for the district in which the income tax return of the taxpayer is required to be filed, a certificate from the Federal Communications Commission clearly identifying the property and showing that the sale or exchange of such property is necessary or appropriate to effectuate the policies of the Commission with respect to the ownership and control of radio broadcasting stations. Such certificate shall be accompanied by a detailed statement showing: The kind of property, the date of acquisition, the cost or other basis of the property, the date of sale or exchange, the name and address of the transferee, and the amount of money and the fair market value of the property other than money received upon such sale or exchange.

(b) Section 1071 applies only in the case of a sale or exchange made necessary by reason of the Federal Communications Commission's policies as to ownership or control of radio facilities. Section 1071 does not apply in the case of a sale or exchange made necessary as a result of other matters, such as the operation of a broadcasting station in a manner determined by the Commission to be not in the public interest or in violation of Federal or State law.

(c) An election to have the benefits of section 1071 shall be made in the manner prescribed in § 1.1071–4.

(d) For purposes of section 1071, the term "radio broadcasting" includes telecasting.

§ 1.1071–2 NATURE AND EFFECT OF ELECTION.—(a) *Alternative elections.*—(1) A taxpayer entitled to the benefits of section 1071 in respect of a sale or exchange of property may elect—

(i) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033; or

(ii) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033, and in addition elect to reduce the basis of property, in accordance with the regulations prescribed in § 1.1071–3, by all or part of the gain that would otherwise be recognized under section 1033; or

(iii) To reduce the basis of property, in accordance with the regulations prescribed in § 1.1071–3, by all or part of the gain realized upon the sale or exchange.

(2) The effect of the provisions of subparagraph (1) above is, in general, to grant the taxpayer an election to treat the proceeds of the sale or exchange as the proceeds of an involuntary conversion subject to the provisions of section 1033, and a further election to reduce the basis of certain property owned by the taxpayer by the amount of the gain realized upon the sale or exchange to the extent of that portion of the proceeds which is not treated as the proceeds of an involuntary conversion.

(3) An election in respect to a sale or exchange under section 1071 shall be irrevocable and binding for the taxable year in which the sale or exchange takes place and for all subsequent taxable years.

(b) *Application of section 1033.*—(1) If the taxpayer elects, under either paragraph (a) (1) (i) or (ii) above, to treat the sale or exchange as an involuntary conversion, the provisions of section 1033, as modified by section 1071, together with the regulations prescribed under such sections, shall be applicable in determining the amount of recognized gain and the basis of property acquired as a result of such sale or exchange. For the purposes of section 1071 and the regulations thereunder, stock of a corporation operating a radio broadcasting station shall be treated as property similar or related in service or use to the property sold or exchanged. Securities of such a corporation other than stock, or securities of a corporation not operating a radio broadcasting station, do not constitute property similar or related in service or use to the property sold or exchanged. If the taxpayer exercises the election referred to in paragraph (a) (1) (i) above, the gain realized upon such sale or exchange shall be recognized to the extent of that part of the money received upon the sale or exchange which is not expended in the manner prescribed in section 1033 and the regulations thereunder. If, however, the taxpayer exercises the elections referred to in paragraph (a) (1) (ii) above, the amount of the gain which would be recognized, determined in the same manner as in the case of an election under paragraph (a) (1) (i) above, shall not be recognized but shall be applied to reduce the basis of property, remaining in the hands of the taxpayer after such sale or exchange or acquired by him during the same taxable year, which is of a character subject to the allowance for depreciation under section 167. Such reduction of basis shall be made in accordance with and under the conditions prescribed by § 1.1071–3.

(2) In the application of section 1033 to determine the recognized gain and the basis of property acquired as a result of a sale or exchange pursuant to an election under paragraph (a) (1) (i) or (ii) above, the entire amount of the proceeds of such sale or exchange shall be taken into account.

(c) *Example.* The application of the provisions of section 1071 may be illustrated by the following example:

Example. A, who makes his return on a calendar year basis, sold in 1954, for $100,000 cash, stock of X Corporation, which operates a radio broadcasting station. A's basis of this stock was $75,000. The sale was certified by the Federal Communications Commission as provided in section 1071. Soon after, in the same taxable year, A used $50,000 of the proceeds of the sale to purchase stock in Y Corporation, which operates a radio broadcasting station. A elected in his 1954 return to treat such sale and purchase as an involuntary conversion subject to the provisions of section 1033. He also elected at the same time to reduce the basis of depreciable property by the amount of the gain that otherwise would be recognized under the provisions of section 1033, as made applicable by section 1071. The sale results in a recognized gain of $25,000 under section 1033. However, this gain is not recognized in this case because the taxpayer elected to reduce the basis of other property by the amount of the gain. This may be shown as follows:

(1) Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Gain realized	$25,000
Proceeds of sale	$100,000
Amount expended to replace property sold	50,000
Amount not expended in manner prescribed in section 1033	$50,000
Realized gain, recognized under section 1033 (not to exceed the unexpended portion of proceeds of sale)	$25,000
Less: Amount applied as a reduction of basis of depreciable property	25,000
Recognized gain for tax purposes	None

(2) The basis of Y Corporation stock in the hands of A is $50,000, computed in accordance with section 1033 and the regulations prescribed under that section. The $50,000 basis is computed as follows:

Basis of property sold (converted)	$75,000
Less: Amount of proceeds not expended	50,000
Balance	$25,000
Plus amount of gain recognized under section 1033	25,000
Basis of Y Corporation stock in A's hands	$50,000

§ 1.1071–3 Reduction of Basis of Property Pursuant to Election Under Section 1071.—(a) *General rule.*—(1) In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1, which adjustments are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in the amount of the unrecognized gain under section 1071, if the taxpayer so elects. Such further adjustment shall be made only with respect to the cost or other basis of property which is of a character subject to the allowance for depreciation under section

167 (whether or not used in connection with a broadcasting business), and which remains in the hands of the taxpayer immediately after the sale or exchange in respect of which the election is made, or which is acquired by the taxpayer in the same taxable year in which sale or exchange occurs. If the property is in the hands of the taxpayer immediately after the sale or exchange, the time or reduction of the basis is the date of the sale or exchange; in all other cases the time of reduction of the basis is the date of acquisition.

(2) The reduction of basis under section 1071 in the amount of the unrecognized gain shall be made in respect to the cost of other basis, as of the time prescribed, of all units of property of the specified character. The cost or other basis of each unit shall be decreased in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) of such unit bears to the aggregate of such adjusted basis of all units of such property, but the amount of the decreases shall not be more than the amount of such adjusted basis. If in the application of such rule the adjusted basis of any unit is reduced to zero, the process shall be repeated to reduce the adjusted basis of the remaining units of property by the portion of the unrecognized gain which is not absorbed in the first application of the rule. For such purpose the "adjusted basis" of the remaining units shall be the adjusted basis for determining gain reduced by the amount of the adjustment previously made under this section. The process shall be repeated until the entire amount of the unrecognized gain has been absorbed.

(3) The application of the provisions of this section may be illustrated by the following example:

Example. Using the facts given in the example set forth in § 1.1071–2(c), except that the taxpayer elects to reduce the basis of depreciable property in accordance with paragraph (a)(1)(iii) of § 1.1071–2. the computation may be illustrated as follows:

Sale price of X Corporation stock		$100,000
Basis for gain or loss		75,000
Realized gain (recognized except for the election under § 1071–1)		$25,000
Adjusted basis of other depreciable property in hands of A immediately after sale:		
Building	$80,000	
Transmitter	16,000	
Fixtures	4,000	
Total	$100,000	
Computation of reduction:		
Building $\frac{80,000}{100,000} \times \$25,000$ (gain)		$20,000
Transmitter $\frac{16,000}{100,000} \times \$25,000$		4,000
Fixtures $\frac{4,000}{100,000} \times \$25,000$		1,000
Total reduction		$25,000

New basis of assets:	
Building ($80,000 minus $20,000)	$60,000
Transmitter ($16,000 minus $4,000)	12,000
Fixtures ($4,000 minus $1,000)	3,000
Total adjusted basis after reduction under section 1071	$75,000
Realized gain upon sale of X Corporation stock	$25,000
Less: Amount applied as a reduction to basis of depreciable property	25,000
Recognized gain for tax purposes	None

(b) *Special cases.*—With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property of the class specified in section 1071 and this section adjusted in a manner different from the general rule set forth in paragraph (a) above. Variations from such general rule may, for example, involve adjusting the basis of only certain units of such property. The request for variations from such general rule should be filed by the taxpayer with his return for the taxable year in which he elects to have the basis of property reduced under section 1071. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121.

§ 1.1071–4 Manner of Election.—(a) An election under the provisions of section 1071 shall be in the form of a written statement and shall be executed and filed in duplicate. Such statement shall be signed by the taxpayer or his authorized representative. In the case of a corporation the statement shall be signed with the corporate name, followed by the signature and title of an officer of the corporation empowered to sign for the corporation, and the corporate seal must be affixed. An election under section 1071 to reduce the basis of property and an election under such section to treat the sale or exchange as an involuntary conversion under section 1033 may be exercised independently of each other. An election under section 1071 must be filed with the return for the taxable year in which the sale or exchange occurs. Where practicable, the certificate of the Federal Communications Commission required by § 1.1071–1 should be filed with the election.

(b) If, in pursuance of an election to have the basis of its property adjusted under section 1071, the taxpayer desires to have such basis adjusted in any manner different from the general rule set forth in § 1.1071–3(a), the precise method (including allocation of amounts) should be set forth in detail on separate sheets accompanying the election. Consent by the Commissioner to any departure from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121.

EXCHANGES IN OBEDIENCE TO S. E. C. ORDERS

§ 1.1081 Statutory Provisions; Exchanges and Distributions in Obedience to Orders of the Securities and Exchange Commission; Nonrecognition of Gain or Loss.

SEC. 1081. NONRECOGNITION OF GAIN OR LOSS ON EXCHANGES OR DISTRIBUTION 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.

(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 be 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.

§ 1.1081–1 TERMS USED.—The following terms, when used in this section and §§ 1.1081–2 to 1.1083–1, inclusive, shall have the meanings assigned to them in section 1083: "Order of the Securities and Exchange Commission"; "registered holding company"; "holding company system"; "associate company"; "majority-owned subsidiary company"; "system group"; "nonexempt property"; and "stock or securities". Any other term used in this section and §§ 1.1081–2, to 1.1083–1, inclusive, which is defined in the Internal Revenue Code of 1954, shall be given the respective definition contained in such Code.

§ 1.1081–2 PURPOSE AND SCOPE OF EXCEPTION.—(a) The general rule is that the entire amount of gain or loss from the sale or exchange of property is to be recognized (see section 1002) and that the entire amount received as a dividend is to be included in gross income. (See sections 61 and 301.) Exceptions to the general rule are provided elsewhere in subchapters C and O of chapter 1, one of which is that made by section 1081 with respect to exchanges, sales, and distributions specifically described in section 1081. Section 1081 provides

the extent to which gain or loss is not to be recognized on (1) the receipt of a distribution described in section 1081(c)(2), or (2) an exchange or sale, or the receipt of a distribution, made in obedience to an order of the Securities and Exchange Commission, which is issued to effectuate the provisions of section 11(b) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k(b)). Section 331 provides that a distribution in liquidation of a corporation shall be treated as an exchange. Such distribution is to be treated as an exchange under the provisions of sections 1081 to 1083, inclusive. The order of the Securities and Exchange Commission must be one requiring or approving action which the Commission finds to be necessary or appropriate to effect a simplification or geographical integration of a particular public utility holding company system. For specific requirements with respect to an order of the Securities and Exchange Commission, see section 1081(f).

(b) The requirements for nonrecognition of gain or loss as provided in section 1081 are precisely stated with respect to the following general types of transactions:

(1) The exchange that is provided for in section 1081(a), in which stock or securities in a registered holding company or a majority-owned subsidiary company are exchanged for stock or securities.

(2) The exchange that is provided for in section 1081(b), in which a registered holding company or an associate company of a registered holding company exchanges property for property.

(3) The distribution that is provided for in section 1081(c)(1), in which stock or securities are distributed to a shareholder in a corporation, which is a registered holding company or a majority-owned subsidiary company, or the distribution that is provided for in section 1081(c)(2), in which a corporation distributes to a shareholder, rights to acquire common stock in a second corporation.

(4) The transfer that is provided for in section 1081(d), in which a corporation which is a member of a system group transfers property to another member of the same system group.

Certain rules with respect to the receipt of nonexempt property on an exchange described in section 1081(a) are prescribed in section 1081(e).

(c) These exceptions to the general rule are to be strictly construed. Unless both the purpose and the specific requirements of sections 1081 to 1083, inclusive, are clearly met, the recognition of gain or loss upon the exchange, sale, or distribution will not be postponed under those sections. Moreover, even though a taxable transaction occurs in connection or simultaneously with a realization of gain or loss to which nonrecognition is accorded, nevertheless, nonrecognition will not be accorded to such taxable transaction. In other words, the provisions of section 1081 do not extend in any case to gain or loss other than that realized from and directly attributable to a disposition of property as such, or the receipt of a corporate distribution as such, in an exchange, sale, or distribution specifically described in section 1081.

(d) The application of the provisions of sections 1081 to 1083, inclusive, is intended to result only in postponing the recognition of

gain or loss until a disposition of property is made which is not covered by such provisions, and, in the case of an exchange or sale subject to the provisions of section 1081(b), in the reduction of basis of certain property. The provisions of section 1082 with respect to the continuation of basis and the reduction in basis are designed to effect these results. Although the time of recognition may be shifted, there must be a true reflection of income in all cases, and it is intended that the provisions of sections 1081 to 1083, inclusive, shall not be construed or applied in such a way as to defeat this purpose.

§ 1.1081–3 EXCHANGES OF STOCK OR SECURITIES SOLELY FOR STOCK OR SECURITIES.—The exchange, without the recognition of gain or loss, that is provided for in section 1081(a) must be one in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are exchanged solely for stock or securities other than stock or securities which constitute nonexempt property. An exchange is not within the provisions of section 1081(a) unless the stock or securities transferred and those received are stock or securities as defined by section 1083(f). The stock or securities which may be received without the recognition of gain or loss are not limited to stock or securities in the corporation from which they are received. An exchange within the provisions of section 1081(a) may be a transaction between the holder of stock or securities and the corporation which issued the stock or securities. Also the exchange may be made by a holder of stock or securities with an associate company (i. e., a corporation in the same holding company system with the issuing corporation) which is a registered holding company or a majority-owned subsidiary company. In either case, the nonrecognition provisions of section 1081(a) apply only to the holder of the stock or securities. However, the transferee corporation must be acting in obedience to an order of the Securities and Exchange Commission directed to such corporation, if no gain or loss is to be recognized to the holder of the stock or securities who makes the exchange with such corporation. See also section 1081(b), in case the holder of the stock or securities is a registered holding company or an associate company of a registered holding company. An exchange is not within the provisions of section 1081(a) if it is within the provisions of section 1081(d), relating to transfers within a system group. For treatment when nonexempt property is received, see section 1081(e); for further limitations, see section 1081(f).

§ 1.1081–4 EXCHANGES OF PROPERTY FOR PROPERTY BY CORPORATIONS.—(a) *Application of section 1081(b).*—Section 1081(b) applies only to the transfers specified therein with respect to which section 1081(d) is inapplicable, and deals only with such transfers if gain is realized upon the sale or other disposition effected by such transfers. If loss is realized section 1081(b) is inapplicable and the application of other provisions of subtitle A must be determined. See section 1081(g). If section 1081(b) is applicable, the other provisions of subchapters C and O relating to the nonrecognition of gain are inapplicable, and the conditions under which, and the extent to which, the realized gain is not recognized are set forth in paragraphs (b), (c), (d), (e), and (f) below.

(b) *Nonrecognition of gain; no nonexempt proceeds.*—No gain is recognized to a transferor corporation upon the sale or other disposi-

tion of property transferred by such transferor corporation in exchange solely for property other than nonexempt property, as defined in section 1083(e), but only if all of the following requirements are satisfied:

(1) The transferor corporation is, under the definition in section 1083(b), a registered holding company or an associate company of a registered holding company;

(2) Such transfer is in obedience to an order of the Securities and Exchange Commission (as defined in section 1083(a)) and such order satisfies the requirements of section 1081(f);

(3) The transferor corporation has filed the required consent to the regulations under section 1082(a)(2) (see paragraph (g) below); and

(4) The entire amount of the gain, as determined under section 1001, can be applied in reduction of basis under section 1082(a)(2).

(c) *Nonrecognition of gain; nonexempt proceeds.*—If the transaction would be within the provisions of paragraph (b) above if it were not for the fact that the property received in exchange consists in whole or in part of nonexempt property (as defined in section 1083(e)), then no gain is recognized if such nonexempt property, or an amount equal to the fair market value of such nonexempt property at the time of the transfer,

(1) Is expended within the required 24-month period for property other than nonexempt property; or

(2) Is invested within the required 24-month period as a contribution to the capital, or as paid-in surplus, of another corporation;

but only if the expenditure or investment is made

(3) In accordance with an order of the Securities and Exchange Commission (as defined in section 1083(a)) which satisfies the requirements of section 1081(f) and which 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; and

(4) The required consent, waiver, and bond have been executed and filed. See paragraphs (g) and (h) below.

(d) *Recognition of gain in part; insufficient expenditure or investment in case of nonexempt proceeds.*—If the transaction would be within the provisions of paragraph (c) above if it were not for the fact that the amount expended or invested is less than the fair market value of the nonexempt property received in exchange, then the gain, if any, is recognized, but in an amount not in excess of the amount by which the fair market value of such nonexempt property at the time of the transfer exceeds the amount so expended and invested.

(e) *Items treated as expenditures for the purpose of paragraphs (c) and (d) of this section.*—For the purposes of paragraphs (c) and (d) above, the following are treated as expenditures for property other than nonexempt property:

(1) 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);

(2) 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; and

(3) 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.

(f) *Recognition of gain in part; inability to reduce basis.*—If the transaction would be within the provisions of paragraph (b) or (c) above if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082(a)(2), then the gain, if any, is recognized, but in an amount not in excess of the amount which cannot be so applied in reduction of basis. If the transaction would be within the provisions of paragraph (d) above, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082(a)(2), then the gain, if any, is recognized but in an amount not in excess of the aggregate of—

(1) The amount of gain which would be recognized under paragraph (d) of this section if there were no inability to reduce basis under section 1082(a)(2); and

(2) The amount of gain which cannot be applied in reduction of basis under section 1082(a)(2).

(g) *Consent to regulations under section 1082(a)(2).*—To be entitled to the benefits of the provisions of section 1081(b), a corporation must file with its return for the taxable year in which the transfer occurs a consent to have the basis of its property adjusted under section 1082(a)(2) (see § 1.1082–3), in accordance with the provisions of the regulations in effect at the time of filing of the return for the taxable year in which the transfer occurs. Such consent shall be made in duplicate on Form 982A in accordance with these regulations and instructions on the form or issued therewith.

(h) *Requirements with respect to expenditure or investment.*—If the full amount of the expenditure or investment required for the application of paragraph (c) above has not been made by the close of the taxable year in which such transfer occurred, the taxpayer shall file with the return for such year an application for the benefit of the 24-month period for expenditure and investment, reciting the nature and time of the proposed expenditure or investment. When requested by the district director of internal revenue, the taxpayer shall execute and file (at such time and in such form) such waiver of the statute of limitations with respect to the assessment of deficiencies (for the taxable year of the transfer and for all succeeding taxable years in any of which falls any part of the period beginning with the date of the transfer and ending 24 months thereafter) as the district director may specify, and such bond with such surety as the district director may require, in an amount not in excess of double the estimated maximum income tax which would be payable if the corporation does not make the required expenditure or investment within the required 24-month period.

§ 1.1081–5 Distribution Solely of Stock or Securities.—(a) *In general.*—If, without any surrender of his stock or securities as defined in section 1083(f), a shareholder in a corporation which is a registered holding company or a majority-owned and subsidiary com-

pany receives stock or securities in such corporation or owned by such corporation, no gain to the shareholder will be recognized with respect to the stock or securities received by such shareholder which do not constitute nonexempt property, if the distribution to such shareholder is made by the distributing corporation in obedience to an order of the Securities and Exchange Commission directed to such corporation. A distribution is not within the provisions of section 1081(c)(1) if it is within the provisions of section 1081(d), relating to transfers within a system group. A distribution is also not within the provisions of section 1081(c)(1) if it involves a surrender by the shareholder of stock or securities or a transfer by the shareholder of property in exchange for the stock or securities received by the shareholder. For further limitations, see section 1081(f).

(b) *Special rule.*—(1) If there is distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, no gain to the shareholder from the receipt of the rights shall be recognized, but only if all the following requirements are met:

(i) The rights are received by the shareholder without the surrender by the shareholder of any stock in the distributing corporation,

(ii) 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 (15 U. S. C. 79c) that the distributing corporation is exempt from any provision or provisions of such Act, and

(iii) Before January 1, 1958, the distributing corporation disposes of all the common stock in the second corporation which it owns.

(2) The distributing corporation shall, as soon as practicable, notify the district director of internal revenue in whose district the corporation's income tax return and supporting data was filed (see § 1.1081–11(g)), as to whether or not requirement (iii) of paragraph (b)(1) above has been met. If such requirement has not been met, the periods of limitation (sections 6501 and 6502) with respect to any deficiency, including interest and additions to the tax, resulting solely from the receipt of such rights to acquire stock, shall include one year immediately following the date of such notification; and assessment and collection shall be made notwithstanding any provisions of law or rule of law which would otherwise prevent such assessment and collection.

§ 1.1081–6 Transfers Within System Group.—(a) The nonrecognition of gain or loss provided for in section 1081(d)(1) is applicable to an exchange of property for other property (including money and other nonexempt property) between corporations which are all members of the same system group. The term "system group" is defined in section 1083(d).

(b) Section 1081(d)(1) also provides for nonrecognition of gain to a corporation which is a member of a system group if property (including money or other nonexempt property) is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, without the surrender by such shareholder of stock or securities in the distributing corporation.

(c) As stated in § 1.1081–2, nonrecognition of gain or loss will not be accorded to a transaction not clearly provided for in sections 1081 to 1083, inclusive, even though such transaction occurs simultaneously or in connection with an exchange, sale, or distribution to which nonrecognition is specifically accorded. Therefore, nonrecognition will not be accorded to any gain or loss realized from the discharge, or the removal of the burden, of the pecuniary obligations of a member of a system group, even though such obligations are acquired upon a transfer or distribution specifically described in section 1081(d)(1); but the fact that the acquisition of such obligations was upon a transfer or distribution specifically described in section 1081(d)(1) will, because of the basis provisions of section 1082(d), affect the cost to the member of such discharge or its equivalent. Thus, section 1081(d)(1) does not provide for the nonrecognition of any gain or loss realized from the discharge of the indebtedness of a member of a system group as the result of the acquisition in exchange, sale, or distribution of its own bonds, notes, or other evidences of indebtedness which were acquired by another member of the same system group for a consideration less or more than the issuing price thereof (with proper adjustments for amortization of premiums or discounts).

(d) The provisions of paragraph (c) above may be illustrated by the following example:

Example. Suppose that the A Corporation and the B Corporation are both members of the same system group; that the A Corporation holds at a cost of $900 a bond issued by the B Corporation at par, $1,000; and that the A Corporation and the B Corporation enter into an exchange subject to the provisions of section 1081(d)(1) in which the $1,000 bond of the B Corporation is transferred from the A Corporation to the B Corporation. The $900 basis reflecting the cost to the A Corporation which would have been the basis available to the B Corporation if the property transferred to it had been something other than its own securities (see § 1.1082–6) will, in this type of transaction, reflect the cost to the B Corporation of effecting a retirement of its own $1,000 bond. The $100 gain of the B Corporation reflected in the retirement will therefore be recognized.

(e) No exchange or distribution may be made without the recognition of gain or loss as provided for in section 1081(d)(1), unless all the corporations which are parties to such exchange or distribution are acting in obedience to an order of the Securities and Exchange Commission. If an exchange or distribution is within the provisions of section 1081(d)(1) and also may be considered to be within some other provisions of section 1081, it shall be considered that only the provisions of section 1081(d)(1) apply and that the nonrecognition of gain or loss upon such exchange or distribution is by virtue of that section.

§ 1.1081–7 Sale of Stock or Securities Received Upon Exchange by Members of System Group.—(a) Section 1081(d)(2) provides that to the extent that property received upon an exchange by corporations which are members of the same system group consists of stock or securities issued by the corporation from which such property was received, such stock or securities may, under certain specifically de-

scribed circumstances, be sold to a party not a member of the system group, without the recognition of gain or loss to the selling corporation. The nonrecognition of gain or loss is limited, in the case of stock, to a sale of stock which is preferred as to both dividends and assets. The stock or securities must have been received upon an exchange with respect to which section 1081(d)(1) operated to prevent recognition of gain or loss to any party to the exchange. Nonrecognition of gain or loss upon the sale of such stock or securities is permitted only if the proceeds derived from the sale are applied in retirement or cancellation of stock or securities of the selling corporation which were outstanding at the time the exchange was made. It is also essential to nonrecognition of gain or loss upon the sale that both the sale of the stock or securities and the application of the proceeds derived therefrom be made in obedience to an order of the Securities and Exchange Commission. If any part of the proceeds derived from the sale is not applied in making the required retirement or cancellation of stock or securities and if the sale is otherwise within the provisions of section 1081(d)(2), the gain resulting from the sale shall be recognized, but in an amount not in excess of the proceeds which are not so applied. In any event, if the proceeds derived from the sale of the stock or securities exceed the fair market value of such stock or securities at the time of the exchange through which they were acquired by the selling corporation, the gain resulting from the sale is to be recognized to the extent of such excess. Section 1081(d)(2) does not provide for the nonrecognition of any gain resulting from the retirement of bonds, notes, or other evidences of indebtedness for a consideration less than the issuing price thereof. Also, that section does not provide for the nonrecognition of gain or loss upon the sale of any stock or securities received upon a distribution or otherwise than upon an exchange.

(b) The application of paragraph (a) above may be illustrated by the following example:

Example. The X corporation and the Y corporation, both of which make their income tax returns on a calendar year basis, are members of the same system group. As part of an exchange to which section 1081(d)(1) is applicable the Y Corporation on June 1, 1954, issued to the X Corporation 1,000 shares of class A stock, preferred as to both dividends and assets. The fair market value of such stock at the time of issuance was $90,000 and its basis to the X Corporation was $75,000. On December 1, 1954, in obedience to an appropriate order of the Securities and Exchange Commission, the X Corporation sells all of such stock to the public for $100,000 and applies $95,000 of this amount to the retirement of its own bonds, which were outstanding on June 1, 1954. The remaining $5,000 is not used to retire any of the X Corporation's stock or securities. Of the total gain of $25,000 realized on the disposition of the Y Corporation stock, only $10,000 is recognized (the difference between the fair market value of the stock when acquired and the amount for which it was sold), since such amount is greater than the portion ($5,000) of the proceeds not applied to the retirement of the X Corporation's stock or securities. If in this example the stock acquired by the X Corporation had not been stock of the Y Corporation

issued to the X Corporation or if it had been stock not preferred as to both dividends and assets, the full amount of the gain ($25,000) realized upon its disposition would have been recognized, regardless of what was done with the proceeds.

§ 1.1081-8 Exchanges in Which Money or Other Nonexempt Property Is Received.—(a) Under section 1081(e)(1), if in any exchange (not within any of the provisions of section 1081(d)) in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary are exchanged for stock or securities as provided for in section 1081(a), there is received by the taxpayer money or other nonexempt property (in addition to property permitted to be received without recognition of gain), then—

(1) The gain, if any, to the taxpayer is to be recognized in an amount not in excess of the sum of the money and the fair market value of the other nonexempt property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent.

(b) If money or other nonexempt property is received from a corporation in an exchange described in paragraph (a) above and if the distribution of such money or other nonexempt property by or on behalf of such corporation has the effect of the distribution of a taxable dividend, then, as provided in section 1081(e)(2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) the remainder of the gain so recognized shall be taxed as a gain from the exchange of property.

§ 1.1081-9 Requirements With Respect to Order of Securities and Exchange Commission.—The term "order of the Securities and Exchange Commission" is defined in section 1083(a). In addition to the requirements specified in that definition, section 1081(f) provides that, except in the case of a distribution described in section 1081(c)(2), the provisions of section 1081 shall not apply to an exchange, expenditure, investment, distribution, or sale unless each of the following requirements is met:

(a) The order of the Securities and Exchange Commission must recite that the 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 (15 U. S. C. 79k(b)).

(b) The order shall specify and itemize the stocks and securities and other property (including money) which are ordered to be acquired, transferred, received, or sold upon such exchange, acquisition, expenditure, distribution, or sale and, in the case of an investment, the investment to be made, so as clearly to identify such property.

(c) The exchange, acquisition, expenditure, investment, distribution, or sale shall be made in obedience to such order and shall be completed within the time prescribed in such order.

These requirements were not designed merely to simplify the administration of the provisions of section 1081, and they are not to be

considered as pertaining only to administrative matters. Each one of the three requirements is essential and must be met if gain or loss is not to be recognized upon the transaction.

§ 1.1081–10 Nonapplication of Other Provisions of the Internal Revenue Code of 1954.—The effect of section 1081(g) is that an exchange, sale, or distribution which is within section 1081 shall, with respect to the nonrecognition of gain or loss and the determination of basis, be governed only by sections 1081 to 1083, inclusive, the purpose being to prevent overlapping of the provisions of such sections and other provisions of subtitle A. In other words, if by virtue of section 1081 any portion of a person's gain or loss on any particular exchange, sale, or distribution is not to be recognized, then the gain or loss of such person shall be nonrecognized only to the extent provided in section 1081, regardless of what the result might have been if sections 1081 to 1085, inclusive, had not been enacted; and similarly, the basis in the hands of such person of the property received by him in such transaction shall be the basis provided by section 1082, regardless of what the basis of such property might have been under section 1011 if sections 1081 to 1083, inclusive, had not been enacted. On the other hand, if section 1081 does not provide for the nonrecognition of any portion of a person's gain or loss (whether or not such person is another party to the same transaction referred to above), then the gain or loss of such person shall be recognized or nonrecognized to the extent provided for by other provisions of subtitle A as if sections 1081 to 1083, inclusive, had not been enacted; and similarly, the basis in his hands of the property received by him in such transaction shall be the basis provided by other provisions of subtitle A as if sections 1081 to 1083, inclusive, had not been enacted.

§ 1.1081–11 Records To Be Kept and Information To Be Filed With Returns.—(a) *Exchanges; holders of stock or securities.*—Every holder of stock or securities who receives stock or securities and other property (including money) upon an exchange shall, if the exchange is made with a corporation acting in obedience to an order of the Securities and Exchange Commission, file as a part of his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A clear description of the stock or securities transferred in the exchange, together with a statement of the cost or other basis of such stock or securities.

(2) The name and address of the corporation from which the stock or securities were received in the exchange.

(3) A statement of the amount of stock or securities and other property (including money) received from the exchange. The amount of each kind of stock or securities and other property received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(b) *Exchanges; corporations subject to S. E. C. orders.*—Each corporation which is a party to an exchange made in obedience to an order of the Securities and Exchange Commission directed to such corporation shall file as a part of its income return for its taxable

year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A copy of the order of the Securities and Exchange Commission directed to such corporation, in obedience to which the exchange was made.

(2) A certified copy of the corporate resolution authorizing the exchange.

(3) A clear description of all property, including all stock or securities, transferred in the exchange, together with a complete statement of the cost or other basis of each class of property.

(4) The date of acquisition of any stock or securities transferred in the exchange, and, if any of such stock or securities were acquired by the corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The name and address of all persons to whom any property was transferred in the exchange.

(6) If any property transferred in the exchange was transferred to another corporation, a copy of any order of the Securities and Exchange Commission directed to the other corporation, in obedience to which the exchange was made by such other corporation.

(7) If the corporation transfers any nonexempt property, the amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the exchange, computed in accordance with the last sentence of § 1.316–2(b).

(8) A statement of the amount of stock or securities and other property (including money) received upon the exchange, including a statement of all distributions or other dispositions made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(9) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(10) The term "exchange" shall, whenever occurring in this paragraph, be read as "exchange, expenditure, or investment".

(c) *Distributions; shareholders.*—Each shareholder who receives stock or securities or other property (including money) upon a distribution made by a corporation in obedience to an order of the Securities and Exchange Commission shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of stock or securities or other property received upon the distribution, including (in case the shareholder is a corporation) a statement of all distributions or other disposition made of such stock or securities or other prop-

erty by the shareholder. The amount of each class of stock or securities and each kind of property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(3) If the shareholder is a corporation, a statement showing as to each class of its stock the number of shares and percentage owned by a registered holding company or a majority-owned subsidiary company of a registered holding company, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(d) *Distributions; distributing corporations subject to S. E. C. orders.*—Every corporation making a distribution in obedience to an order of the Securities and Exchange Commission shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributee upon such distribution including—

(1) A copy of the order of the Securities and Exchange Commission, in obedience to which the distribution was made.

(2) A certified copy of the corporate resolution authorizing the distribution.

(3) A statement of the amount of stock or securities or other property (including money) distributed to each shareholder. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(4) The date of acquisition of the stock or securities distributed, and, if any of such stock or securities were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the distribution, computed in accordance with the last sentence of § 1.316–2(b).

(6) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(e) *Sales by members of system groups.*—Each corporation which is a member of a system group and which in obedience to an order of the Securities and Exchange Commission sells stock or securities received upon an exchange (made in obedience to an order of the Securities and Exchange Commission) and applies the proceeds derived therefrom in retirement or cancellation of its own stock or securities shall file as a part of its income tax return for the taxable year in which the sale is made a complete statement of all facts pertaining to the nonrecognition of gain or loss upon such sale, including—

(1) A copy of the order of the Securities and Exchange Commission in obedience to which the sale was made.

(2) A copy of the order of the Securities and Exchange Commission in obedience to which the proceeds derived from the sale were applied in whole or in part in the retirement or cancellation of its stock or securities.

(3) A certified copy of the corporate resolutions authorizing the sale of the stock or securities and the application of the proceeds derived therefrom.

(4) A clear description of the stock or securities sold, including the name and address of the corporation by which they were issued.

(5) The date of acquisition of the stock or securities sold, together with a statement of the fair market value of such stock or securities at the date of acquisition, and a copy of all orders of the Securities and Exchange Commission in obedience to which such stock or securities were acquired.

(6) The amount of the proceeds derived from such sale.

(7) The portion of the proceeds of such sale which was applied in retirement or cancellation of its stock or securities, together with a statement showing how long such stock or securities were outstanding prior to retirement or cancellation.

(8) The issuing price of its stock or securities which were retired or canceled.

(f) *Section 1081(c)(2) distributions; shareholders.*—Each shareholder who receives a distribution described in section 1081(c)(2) (concerning rights to acquire common stock) shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all the facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of the rights received upon the distribution, stated on the basis of their fair market value at the date of the distribution.

(g) *Section 1081(c)(2) distributions; distributing corporations.*—Every corporation making a distribution described in section 1081(c)(2) (concerning rights to acquire common stock) shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributees upon such distribution including—

(1) A copy of the arrangement forming the basis for the issuance of the order by the Securities and Exchange Commission.

(2) A copy of the order issued by the Securities and Exchange Commission pursuant to section 3 of the Public Utility Holding Company Act of 1935.

(3) A certified copy of the corporate resolution authorizing the arrangement and the distribution.

(4) A statement of the amount of the rights distributed to each shareholder, stated on the basis of their fair market value at the date of the distribution.

(5) The date of acquisition of the stock with respect to which such rights are distributed, and, if any were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(6) The amount of the undistributed earnings and profits of the distributing corporation accumulated after February 28, 1913, to the time of the distribution, computed in accordance with the last sentence of § 1.316–2(b).

(h) *General requirements.*—Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange or distribution to which sections 1081 to 1083, inclusive, are applicable, showing the cost or other basis of the property transferred and the amount of stock or securities and other property (including money) received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received on the exchange or distribution.

§ 1.1082 STATUTORY PROVISIONS; BASIS OF PROPERTY ACQUIRED IN EXCHANGES AND DISTRIBUTIONS MADE IN OBEDIENCE TO ORDERS OF THE SECURITIES AND EXCHANGE COMMISSION.

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 transfered 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.

§ 1.1082–1 BASIS FOR DETERMINING GAIN OR LOSS.—(a) For determining the basis of property acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942, see such section (before its amendment by such Act).

(b) If the property was acquired in a taxable year beginning after December 31, 1941, in any manner described in section 1082 (other than subsection (a)(2)), or section 372 (other than subsection (a)(2)),

of the Internal Revenue Code of 1939 after its amendments, the basis shall be that prescribed in section 1082 with respect to such property. However, in the case of property acquired in a transaction described in section 1081(c)(2), this paragraph is applicable only if the property was acquired in a distribution made in a taxable year subject to the Internal Revenue Code of 1954.

(c) Section 1082 makes provisions with respect to the basis of property acquired in a transfer in connection with which the recognition of gain or loss is prohibited by the provisions of section 1081 with respect to the whole or any part of the property received. In general, and except as provided in § 1.1082–3, it is intended that the basis for determining gain or loss pertaining to the property prior to its transfer, as well as the basis for determining the amount of depreciation or depletion deductible and the amount of earnings or profits available for distribution, shall continue notwithstanding the nontaxable conversion of the asset in form or its change in ownership. The continuance of the basis may be reflected in a shift thereof from one asset to another in the hands of the same owner, or in its transfer with the property from one owner into the hands of another. See also § 1.1081–2.

§ 1.1082–2 Basis of Property Acquired Upon Exchanges Under Section 1081(a) or (e).—(a) In the case of an exchange of stock or securities for stock or securities as described in section 1081(a), if no part of the gain or loss upon such exchange was recognized under section 1081, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

(b) If, in an exchange of stock or securities as described in section 1081(a), gain to the taxpayer was recognized under section 1081(e) on account of the receipt of money, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized upon the exchange. If, upon such exchange, there were received by the taxpayer money and other nonexempt property (not permitted to be received without the recognition of gain), and gain from the transaction was recognized under section 1081(e), the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to the nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange.

(c) Section 1081(e) provides that no loss may be recognized on an exchange of stock or securities for stock or securities as described in section 1081(a), although the taxpayer receives money or other nonexempt property from the transaction. However, the basis of the property (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. The basis must be apportioned to the properties received, and for this purpose there must be allocated to the nonexempt property (other than money) an amount

of such basis equivalent to the fair market value of such nonexempt property at the date of the exchange.

(d) Section 1082(a) does not apply in ascertaining the basis of 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. For the rule in such cases, see section 1082(b).

(e) For purposes of this section, any reference to section 1081 shall be deemed to include a reference to corresponding provisions of prior internal revenue laws.

§ 1.1082–3 Reduction of Basis of Property by Reason of Gain Not Recognized Under Section 1081(b).—(a) *Introductory.*—In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1, and the regulations relating thereto, which are required to be made with respect to the cost or other basis of property, section 1082(a)(2) provides that a further adjustment shall be made in any case in which there shall have been a nonrecognition of gain under section 1081(b). Such further adjustment shall be made with respect to the basis of the property in the hands of the transferor immediately after the transfer and of the property acquired within 24 months after such transfer by an expenditure or investment to which section 1081(b) relates, and on account of which expenditure or investment gain is not recognized. If the property is in the hands of the transferor immediately after the transfer, the time of reduction is the day of the transfer; in all other cases the time of reduction is the date of acquisition. The effect of applying an amount in reduction of basis of property under section 1081(b) is to reduce by such amount the basis for determining gain upon sale or other disposition, the basis for determining loss upon sale or other disposition, the basis for depreciation and for depletion, and any other amount which the Internal Revenue Code of 1954 prescribes shall be the same as any of such bases. For the purposes of the application of an amount in reduction of basis under section 1081(b), property is not considered as having a basis capable of reduction if

(1) It is money, or

(2) If its adjusted basis for determining gain at the time the reduction is to be made is zero, or becomes zero at any time in the application of section 1081(b).

(b) *General rule.*—(1) Section 1082(a)(2) sets forth seven categories of property, the basis of which for determining gain or loss shall be reduced in the order stated.

(2) If any of the property in the first category has a basis capable of reduction, the reduction must first be made before applying an amount in reduction of the basis of any property in the second or in a succeeding category, to each of which in turn a similar rule is applied.

(3) In the application of the rule to each category, the amount of the gain not recognized shall be applied to reduce the cost or other basis of all the property in the category as follows: The cost or other basis (at the time immediately after the transfer or, if the property is not then held but is thereafter acquired, at the time of such acquisition) of each unit of property in the first category shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis at such time for determining gain, determined

without regard to this section) in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) at such time of each unit of property of the taxpayer in that category bears to the aggregate of the adjusted basis (for determining gain, computed without regard to this section) at such time of all the property of the taxpayer in that category. When such adjusted basis of the property in the first category has been thus reduced to zero, a similar rule shall be applied, with respect to the portion of such gain which is unabsorbed in such reduction of the basis of the property in such category, in reducing the basis of the property in the second category. A similar rule with respect to the remaining unabsorbed gain shall be applied in reducing the basis of the property in the next succeeding category.

(c) *Special cases.*—(1) With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property within a particular category specified in section 1082(a)(2) adjusted in a manner different from the general rule set forth in paragraph (b) above. Variations from such general rule may, for example, involve adjusting the basis of only certain units of the taxpayer's propery within a given category. A request for variations from the general rule should be filed by the taxpayer with its income tax return for the taxable year in which the transfer of property has occurred.

(2) Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121. If no such agreement is entered into by the taxpayer and the Commissioner, then the consent filed on Form 982A shall (except as otherwise provided in this subparagraph) be deemed to be a consent to the application of such general rule, and such general rule shall apply in the determination of the basis of the taxpayer's property. If, however, the taxpayer specifically states on such form that it does not consent to the application of the general rule, then, in the absence of a closing agreement, the document filed shall not be deemed a consent within the meaning of section 1081(b)(4).

§ 1.1082–4 Basis of Property Acquired by Corporation Under Section 1081(a), 1081(b), or 1081(e) As Contribution of Capital or Surplus, or in Consideration for its own Stock or Securities.—If, in connection with an exchange of stock or securities for stock or securities as described in section 1081(a), or an exchange of property for property as described in section 1081(b), or an exchange as described in section 1081(e), property is acquired by a corporation by the issuance of its stock or securities, the basis of such property shall be determined under section 1082(b). If the corporation issued its stock or securities as part or sole consideration for the property acquired, the basis of the property in the hands of the acquiring corporation is the basis (adjusted to the date of the exchange) which the property would have had in the hands of the transferor if the transfer had not been made, increased in the amount of gain or decreased in the amount of loss recognized under section 1081 to the transferor upon the transfer. If any property is acquired by a corporation from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property to the corporation is the basis (adjusted to the date of acquisition) of the property in the hands of the transferor.

§ 1.1082–5 Basis of Property Acquired by Shareholder Upon Tax-Free Distribution Under Section 1081(c)(1) or (2).—(a) *Stock or securities.*—If there was distributed 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), and if by virtue of section 1081(c)(1) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the stock or securities received upon the distribution shall be determined in accordance with the following rules:

(1) If the stock or securities received upon the distribution consist solely of stock in the distributing corporation and the stock received is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost of other basis of the old shares of stock divided by the total number of the old and the new shares.

(2) If the stock or securities received upon the distribution are in whole or in part stock in a corporation other than the distributing corporation, or are in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists in whole or in part of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of this subparagraph, stocks or securities in one corporation are different in class from stocks or securities in another corporation, and, in general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security, so that different values may properly be assigned thereto, will constitute a difference in class.

(b) *Stock rights.*—If there was distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, and if by virtue of section 1081(c)(2) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock rights so distributed to the shareholder. The basis of such stock and the stock rights received upon the distribution shall be determined in accordance with the following:

(1) The cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock rights distributed, in proportion to the respective values thereof at the time the rights are issued.

(2) The basis for determining gain or loss from the sale of a right, or from the sale of a share of stock in respect of which the distribution is made, will be the quotient of the cost or other basis, properly adjusted, assigned to the rights or the stock, divided, as the case may be, by the number of rights acquired or by the number of shares of such stock held.

(c) *Cross reference.*—As to the basis of stock or securities distributed by one member of a system group to another member of the same system group, see § 1.1082–6 below.

§ 1.1082–6 Basis of Property Acquired Under Section 1081(d) in Transactions Between Corporations of the Same System Group.—(a) If property was acquired by a corporation which is a member of a system group, from a corporation which is a member of the same system group, upon a transfer or distribution described in section 1081(d)(1), then as a general rule the basis of such property in the hands of the acquiring corporation is the basis which such property would have had in the hands of the transferor if the transfer or distribution had not been made. Except as otherwise indicated in this section, this rule will apply equally to cases in which the consideration for the property acquired consists of stock or securities, money, and other property, or any of them, but it is contemplated that an ultimate true reflection of income will be obtained in all cases, notwithstanding any peculiarities in form which the various transactions may assume. See the example in § 1.1081–6.

(b) An exception to the general rule is provided for in case the property acquired consists of stock or securities issued by the corporation from which such stock or securities were received. If such stock or securities were the sole consideration for the property transferred to the corporation issuing such stock or securities, then the basis of the stock or securities shall be (1) the same as the basis (adjusted to the time of the transfer) of the property transferred for such stock or securities, or (2) the fair market value of such stock or securities at the time of their receipt, whichever is the lower. If such stock or securities constituted only part consideration for the property transferred to the corporation issuing such stock or securities, then the basis shall be an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities on their receipt bears to the total fair market value of the entire consideration received, except that the fair market value of such stock or securities at the time of their receipt shall be the basis therefor, if such value is lower than such amount.

(c) The application of paragraph (b) may be illustrated by the following examples:

Example (1). Suppose the A Corporation has property with an adjusted basis of $600,000 and, in an exchange in which section 1081(d)(1) is applicable, transfers such property to the B Corporation in exchange for a total consideration of $1,000,000, consisting of (1) cash in the amount of $100,000, (2) tangible property having a fair market value of $400,000 and an adjusted basis in the hands of the B Corporation of $300,000, and (3) stock or securities issued by the B Corporation with a par value and a fair market value as of the date of their receipt in the amount of

$500,000. The basis to the B Corporation of the property received by it is $600,000, which is the adjusted basis of such property in the hands of the A Corporation. The basis to the A Corporation of the assets (other than cash) received by it is as follows: Tangible property, $300,000, the adjusted basis of such property to the B Corporation, the former owner; stock or securities issued by the B Corporation, $300,000, an amount equal to 500,000/1,000,000ths of $600,000.

Example (2). Suppose that in example (1) the property of the A Corporation transferred to the B Corporation had an adjusted basis of $1,100,000 instead of $600,000, and that all other factors in the example remain the same. In such case the basis to the A Corporation of the stock or securities in the B Corporation is $500,000, which was the fair market value of such stock or securities at the time of their receipt by the A Corporation, because this amount is less than the amount established as 500,000/1,000,000ths of $1,100,000 or $550,000.

§ 1.1083 STATUTORY PROVISIONS; EXCHANGES AND DISTRIBUTIONS IN OBEDIENCE TO ORDERS OF THE SECURITIES AND EXCHANGE COMMISSION; DEFINITIONS.

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 2[illegible], 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).

§ 1.1083–1 DEFINITIONS.—(a) *Order of the Securities and Exchange Commission.*—(1) An order of the Securities and Exchange Commission as defined in section 1083(a) must be issued after May 28, 1938 (the date of the enactment of the Revenue Act of 1938), and must be issued under the authority of section 11(b) or 11(e) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k (b), (e), to effectuate the provisions of section 11(b) of such Act. In all cases the order must become or have become final in accordance with law; i. e., it must be valid, outstanding, and not subject to further appeal. See further sections 1083(a) and 1081(f).

(2) Section 11(b) of the Public Utility Holding Company Act of 1935 provides:

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: *Provided, however*, That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

(A) Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

(B) All of such additional systems are located in one State or in adjoining States, or in a contiguous foreign country; and

(C) The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation. The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company. The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

(3) Section 11(e) of the Public Utility Holding Company Act of 1935 provides:

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or

as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

(b) *Registered holding company, holding-company system, and associate company.*—(1) Under section 5 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79e), any holding company may register by filing with the Securities and Exchange Commission a notification of registration, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. A holding company shall be deemed to be registered upon receipt by the Securities and Exchange Commission of such notification of registration. As used in this subtitle, the term "registered holding company" means a holding company whose notification of registration has been so received and whose registration is still in effect under section 5 of the Public Utility Holding Company Act of 1935. Under section 2(a)(7) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b(a)(7)), a corporation is a holding company (unless it is declared not to be such by the Securities and Exchange Commission), if such corporation directly or indirectly owns, controls, or holds with power to vote 10 percent or more of the outstanding voting securities of a public-utility company (i. e., an electric utility company or a gas utility company as defined by such act) or of any other holding company. A corporation is also a holding company if the Securities and Exchange Commission determines, after notice and opportunity for hearing, that such corporation directly or indirectly exercises (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility company (i. e., an electric utility company or a gas utility company as defined by such act) or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such corporation be subject to the obligations, duties, and liabilities imposed upon holding companies by the Public Utility Holding Company Act of 1935 (15 U. S. C. c. 2C). An electric utility company is defined by section 2(a)(3) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b(a)(3)) to mean a company which owns or operates facilities used for the generation, transmission, or distribution of electrical energy for sale, other than sale to tenants or employees of the company operating such facilities for their own use and not for resale; and a gas utility company is defined by section 2(a)(4) of such act (15 U. S. C. 79b (a)(4)), to mean a company which owns or operates facilities used for the distribution at retail (other than distribution

only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power. However, under certain conditions the Securities and Exchange Commission may declare a company not to be an electric utility company or a gas utility company, as the case may be, in which event the company shall not be considered an electric utility company or a gas utility company.

(2) The term "holding company system" has the meaning assigned to it by section 2(a)(9) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b(a)(9)), and hence means any holding company, together with all its subsidiary companies (i. e., subsidiary companies within the meaning of section 2(a)(8) of such act (15 U. S. C. 79b(a)(8)), which in general include all companies 10 percent of whose outstanding voting securities is owned directly or indirectly by such holding company and all mutual service companies of which such holding company or any subsidiary company thereof is a member company. The term "mutual service company" means a company approved as a mutual service company under section 13 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79m). The term "member company" is defined by section 2(a)(14) of such act (15 U. S. C. 79b(a)(14)), to mean a company which is a member of an association or group of companies mutually served by a mutual service company.

(3) The term "associate company" has the meaning assigned to it by section 2(a)(10) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b(a)(10)), and hence an associate company of a company is any company in the same holding-company system with such company.

(c) *Majority-owned subsidiary company.*—The term "majority-owned subsidiary company" is defined in section 1083(c). Direct ownership by a registered holding company of more than 50 percent of the specified stock of another corporation is not necessary to constitute such corporation a majority-owned subsidiary company. To illustrate, if the H Corporation, a registered holding company, owns 51 percent of the common stock of the A Corporation and 31 percent of the common stock of the B Corporation, and the A Corporation owns 20 percent of the common stock of the B Corporation (the common stock in each case being the only stock entitled to vote), both the A Corporation and the B Corporation are majority-owned subsidiary companies.

(d) *System group.*—The term "system group" is defined in section 1083(d) to mean one or more chains of corporations connected through stock ownership with a common parent corporation, if at least 90 percent of each class of stock (other than (1) stock which is preferred as to both dividends and assets, and (2) 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 if the common parent corporation owns directly at least 90 percent of each class of stock (other than stock

preferred as to both dividends and assets) of at least one of the other corporations; but no corporation is a member of a system group unless it is either a registered holding company or a majority-owned subsidiary company. While the type of stock which must, for the purpose of this definition, be at least 90 percent owned may be different from the voting stock which must be more than 50 percent owned for the purpose of the definition of a majority-owned subsidiary company under section 1083(c), as a general rule both types of ownership tests must be met under section 1083(d), since a corporation, in order to be a member of a system group, must also be a registered holding company or a majority-owned subsidiary company.

(e) *Nonexempt property.*—The term "nonexempt property" is defined by section 1083(e) to include—

(1) The amount of any consideration in the form of a cancellation or assumption of debts or other liabilities of the transferor (including a continuance of encumbrances subject to which the property was transferred). To illustrate, if in obedience to an order of the Securities and Exchange Commission the X Corporation, a registered holding company, transfers property to the Y Corporation in exchange for property (not nonexempt property) with a fair market value of $500,000, the X Corporation receives $100,000 of nonexempt property, if for example—

(i) The Y Corporation cancels $100,000 of indebtedness owed to it by the X Corporation;

(ii) The Y Corporation assumes an indebtedness of $100,000 owed by the X Corporation to another company, the A Corporation; or

(iii) The Y Corporation takes over the property conveyed to it by the X Corporation subject to a mortgage of $100,000.

(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 which acquired such stock or securities after February 28, 1938, or an associate company of a registered holding company which acquired such stock or securities after February 28, 1938, unless such stock or securities were acquired in obedience to an order of the Securities and Exchange Commission (as defined in section 1083(a)) 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, and are not nonexempt property within the meaning of section 1083(e) (1), (2) or (3).

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in section 1083(e) (2) or (3). The term "the right to receive money" includes, among other items, accounts receivable, claims for damages, and rights to refunds of taxes.

(f) *Stock or securities.*—The term "stock or securities" is defined in section 1083(f) for the purposes of sections 1081 to 1083, inclusive. As therein defined, the term includes voting trust certificates and stock rights or warrants.

WASH SALES OF STOCKS OR SECURITIES

§ 1.1091 Statutory Provisions; Losses From Wash Sales of Stocks or Securities; Basis.

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.

§ 1.1091-1 Losses From Wash Sales of Stock or Securities.—(a) A taxpayer cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date (referred to in this section as the 61-day period), he has acquired (by purchase or by an exchange upon 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. However, this prohibition does not apply (1) in the case of a taxpayer, not a corporation, if the sale or other disposition of stock or securities is made in connection with the taxpayer's trade or business, or (2) in the case of a corporation, a dealer in stock or securities, if the sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer.

(b) Where more than one loss is claimed to have been sustained within the taxable year from the sale or other disposition of stock or securities, the provisions of this section shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition). If the order of disposition of stock or securities disposed of at a loss on the same day cannot be determined, the stock or securities will be considered to have been disposed of in the order in which they were originally acquired (beginning with the earliest acquisition).

(c) Where the amount of stock or securities acquired within the 61-day period 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 those with which the stock or securities acquired are matched in accordance with the following rule: The stock or securities acquired will be matched in accordance with the order of their acquisition (beginning with the earliest acquisition) with an equal number of the shares of stock or securities sold or otherwise disposed of.

(d) Where the amount of stock or securities acquired within the 61-day period 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 resulted in the nondeductibility of the loss shall be those with which the stock or securities disposed of are matched in accordance with the following rule: The stock or securities sold or otherwise disposed of will be matched with an equal number of the shares of stock or securities acquired in accordance with the order of acquisition (beginning with the earliest acquisition) of the stock or securities acquired.

(e) The acquisition of any share of stock or any security which results in the nondeductibility of a loss under the provisions of this section shall be disregarded in determining the deductibility of any other loss.

(f) The word "acquired" as used in this section means acquired by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law, and comprehends cases where the taxpayer has entered into a contract or option within the 61-day period to acquire by purchase or by such an exchange.

(g) The following examples illustrate the application of this section:

Example (1). A, whose taxable year is the calendar year, on December 1, 1954, purchased 100 shares of common stock in the *M* Company for $10,000 and on December 15, 1954, purchased 100 additional shares for $9,000. On January 3, 1955, he sold the 100 shares purchased on December 1, 1954, for $9,000. Because of the provisions of section 1091, no loss from the sale is allowable as a deduction.

Example (2). A, whose taxable year is the calendar year, on September 21, 1954, purchased 100 shares of the common stock of the M Company for $5,000. On December 21, 1954, he purchased 50 shares of substantially identical stock for $2,750, and on December 27, 1954, he purchased 25 additional shares of such

stock for $1,125. On January 3, 1955, he sold for $4,000 the 100 shares purchased on September 21, 1954. There is an indicated loss of $1,000 on the sale of the 100 shares. Since, within the 61-day period, A purchased 75 shares of substantially identical stock, the loss on the sale of 75 of the shares ($3,750−$3,000, or $750) is not allowable as a deduction because of the provisions of section 1091. The loss on the sale of the remaining 25 shares ($1,250−$1,000, or $250) is deductible subject to the limitations provided in sections 267 and 1211. The basis of the 50 shares purchased December 21, 1954, the acquisition of which resulted in the nondeductibility of the loss ($500) sustained on 50 of the 100 shares sold on January 3, 1955, is $2,500 (the cost of 50 of the shares sold on January 3, 1955) +$750 (the difference between the purchase price ($2,750) of the 50 shares acquired on December 21, 1954, and the selling price ($2,000) of 50 of the shares sold on January 3, 1955), or $3,250. Similarly, the basis of the 25 shares purchased on December 27, 1954, the acquisition of which resulted in the nondeductibility of the loss ($250) sustained on 25 of the shares sold on January 3, 1955, is $1,250+$125, or $1,375. See § 1.1091–2.

Example (3). A, whose taxable year is the calendar year, on September 15, 1954, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1956, for $4,000. On each of the four days from February 15, 1956, to February 18, 1956, inclusive, he purchased 50 shares of substantially identical stock for $2,000. There is an indicated loss of $1,000 from the sale of the 100 shares on February 1, 1956, but, since within the 61-day period A purchased not less than 100 shares of substantially identical stock, the loss is not deductible. The particular shares of stock the purchase of which resulted in the nondeductibility of the loss are the first 100 shares purchased within such period, that is, the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956. In determining the period for which the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956, were held, there is to be included the period for which the 100 shares purchased on September 15, 1954, and sold on February 1, 1956, were held.

§ 1.1091–2 Basis of Stocks or Securities Acquired in "Wash Sales."—The application of section 1091(d) may be illustrated by the following examples:

Example (1). A purchased a share of common stock of the X Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $90. No loss from the sale is recognized under section 1091. The basis of the new share is $110; that is, the basis of the old share ($100) increased by $10, the excess of the price at which the new share was acquired ($90) over the price at which the old share was sold ($80).

Example (2). A purchased a share of common stock of the Y Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common

stock of the same corporation for $70. No loss from the sale is recognized under section 1091. The basis of the new share is $90; that is, the basis of the old share ($100) decreased by $10, the excess of the price at which the old share was sold ($80) over the price at which the new share was acquired ($70).

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved May 28, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

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SUBCHAPTER P.—CAPITAL GAINS AND LOSSES

PART I.—TREATMENT OF CAPITAL GAINS

SECTION 1201.—ALTERNATIVE TAX

(Also Sections 243, 244, 245, 247, 922, and 941.) Rev. Rul. 56-151

If corporations compute the alternative tax on capital gains provided by section 1201(a) of the Internal Revenue Code of 1954 and are entitled to special deductions for dividends received (sections 243, 244, and 245 of the 1954 Code), the special deduction for dividends paid (section 247), the special deduction for a Western Hemisphere trade corporation (section 922), or the special deduction for a China Trade Act corporation (section 941), the excess of the net long-term capital gain over net short-term capital loss is not to be subtracted from taxable income in determining the amount of such special deductions, as is required by Schedule D, Form 1120, U. S. Corporation Income Tax Return, for both 1954 and 1955.

Line 11 of Schedule D, Form 1120, which shows the taxable income before the deduction for excess net long-term capital gain (line 12) in computing the alternative tax for a corporation, is followed by the parenthetical note: "(When deductions are allowable under sections 243, 244, 245, 247, 922, and 941, disregard lines 11 and 12 and compute taxable income for purposes of the alternative tax (line 13) according to the 'Alternative Tax' instructions on page 4.)." This note on line 11 of Schedule D, Form 1120, for years 1954 and 1955, as well as the portions on page 4 of the instructions accompanying that schedule to which the note referred, should therefore be disregarded.

Accordingly, for taxable years subject to the 1954 Code, the special deductions allowed corporations by the above-cited sections of the 1954 Code are to be based upon taxable income including the excess of net long-term capital gain over net short-term capital loss. Where the changes set forth herein will result in a change in income tax liability for a taxable year in respect of which a return has previously been filed, taxpayers should file amended returns or claims for refund on Form 843 (Claim).

(Also Part II, Section 117(c); Regulations 118, Section 39.117(c)-1.) Rev. Rul. 56-247

In computing the alternative tax pursuant to the provisions of section 1201 of the Internal Revenue Code of 1954 (section 117(c) of the 1939 Code), where a taxpayer's statutory deductions and/or credits exceed his ordinary income (as distinguished from taxable capital gain), the "capital gains tax" provided in section 1201(a) of the 1954 Code, in the case of a corporation, and section 1201(b) of the 1954 Code, in the case of other taxpayers, is to be applied to the taxable long-term capital gain unreduced by the amount of the excess of the statutory deductions and/or credits over ordinary income. See *Walter M. Weil et al.* v. *Commissioner*, 23 T. C. 424.

PART III.—GENERAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

SECTION 1221.—CAPITAL ASSET DEFINED

Treatment of dividends paid on shares of stock sold and held in trust and applied as payments against the principal and interest of a promissory note given for the purchase of the stock. See Rev. Rul. 56-153, page 166.

PART IV.—SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

SECTION 1231.—PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS

Gain from collections on promissory note sold to subsidiary by parent corporation. See Rev. Rul. 56-186, page 441.

SUBCHAPTER Q.—READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

PART I.—INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS

SECTION 1303.—INCOME FROM BACK PAY

Rev. Rul. 56-108

A lump sum payment received by an employee upon discontinuance of his employer's business, which was made in accordance with a union agreement, as severance pay, two-weeks' notice pay and accrued vacation pay is not back pay and does not qualify for treatment under section 1303 of the Internal Revenue Code of 1954.

Advice has been requested whether a lump sum payment made up of severance pay, two-weeks' notice pay, and accrued vacation pay,

received by an employee upon discontinuance of the business of the corporation by which he was employed constitutes back pay.

The taxpayer was an employee of a corporation which discontinued business. An agreement between his employer and a union of which he was a member provided that if an employee was discharged for any reason other than wilful neglect of duty or gross misconduct he would be entitled to severance pay, two-weeks' notice pay, and accrued vacation pay. In accordance with such agreement the person who became unemployed because of discontinuance of the business received a lump sum payment.

Section 1303(b) of the Internal Revenue Code of 1954 provides in part as follows:

> (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.
>
> * * * * * * *

None of the events enumerated in section 1303(b)(1)(A), (B) and (C) of the Code have occurred in the instant case. For the purpose of (D) thereof an event will be considered similar in nature to events enumerated in (A), (B) and (C) only if the circumstances are unusual, if they are the type specified therein, if they operate to defer payment of the remuneration for the services performed and if the payment, except for such circumstances, would have been made prior to the taxable year in which received or accrued. See section 39.107–3 (b) of Regulations 118, applicable under section 1303 of the 1954 Code by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

The payment to the taxpayer was not compensation which would have been paid in a prior period except for the intervention of an event similar in nature to a dispute as to the liability of the employer to pay such remuneration.

Accordingly, it is held that the lump sum payment received by an employee upon discontinuance of his employer's business, which was made in accordance with a union agreement, representing severance pay, two-weeks' notice pay and accrued vacation pay is not back pay and does not qualify for treatment under section 1303 of the Internal Revenue Code of 1954.

PART II.—MITIGATION OF EFFECT OF LIMITATIONS AND OTHER PROVISIONS

SECTION 1311.—CORRECTION OF ERROR

26 CFR 1.1311(a): Statutory provisions; correction of error; general rule. T. D. 6162[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER A, PART 1.—TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Regulations prescribed under subchapter Q—mitigation of effect of limitations and other provisions.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

AUTHORITY: §§ 1.1311 to 1.1315, incl., issued under secs. 1313, 7805, I. R. C. 1954; 68A Stat. 339, 917; 26 U. S. C. 1313, 7805.

On July 12, 1955, notice of proposed rulemaking with respect to regulations under subchapter Q, part II (relating to mitigation of effect of limitations and other provisions), of the Internal Revenue Code of 1954, was published in the Federal Register (20 F. R. 4947). After consideration of such relevant suggestions as were presented by interested persons regarding the proposals, the regulations as so published have been modified and are hereby adopted as set forth below:

MITIGATION OF EFFECT OF LIMITATIONS AND OTHER PROVISIONS

§ 1.1311(a) STATUTORY PROVISIONS; CORRECTION OF ERROR; GENERAL RULE.

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.

§ 1.1311(a)-1 INTRODUCTION.—(a) Part II of subchapter Q provides certain rules for the correction of the effect of an erroneous treatment of an item in a taxable year which is closed by the statute of limitations or otherwise, in cases where, in connection with the ascertainment of the tax for another taxable year, it has been determined that there was an erroneous treatment of such item in the closed year.

[1] The publication of this Treasury Decision in 21 F. R. 890, dated February 9, 1956, contains (1) a series of instructions for modifying the notice of proposed rule making published in 20 F. R. 4947, dated July 12, 1955, and (2) the full context of the regulations with such modifications. As here published, the Treasury Decision reflects the full context of such regulations, with modifications. The individual instructions have been omitted.

(b) In most situations falling within this part the correction of the effect of the error on a closed year can be made only if either the Commissioner or the taxpayer has taken a position in another taxable year which is inconsistent with the erroneous treatment of the item in the closed year. If a refund or credit would result from the correction of the error in the closed year, then the Commissioner must be the one maintaining the inconsistent position. For example, if the taxpayer erroneously included an item of income on his return for an earlier year which is now closed and the Commissioner successfully requires it to be included in a later year, then the correction of the effect of the erroneous inclusion of that item in the closed year may be made since the Commissioner has maintained a position inconsistent with the treatment of such item in such closed year. On the other hand, if an additional assessment would result from the correction of the error in the closed year, then the taxpayer must be the one maintaining the inconsistent position. For example, if the taxpayer deducted an item in an earlier year which is now closed and he successfully contends that the item should be deducted in a later year, then the correction of the effect of the erroneous deduction of that item in the closed year may be made since the taxpayer has taken a position inconsistent with the treatment of such item in such earlier year.

(c) There are two special circumstances which fall within this part but which do not require an inconsistent position be maintained. One of these circumstances relates to the inclusion of an item of income in the correct year and the other relates to the allowance of a deduction in the correct year. In the first situation, if the Commissioner takes the position by a deficiency notice or before the Tax Court that an item of income should be included in the gross income of a taxpayer for a particular year and it is ultimately determined that such item was not so includible, then such item can be included in the income of the proper year if that year was not closed at the time the Commissioner took his position. In the second situation, if the taxpayer claims that a deduction should be allowed for a particular year and it is ultimately determined that the deduction was not allowable in that year, then the taxpayer may take the deduction in the proper year if that year was not closed at the time the taxpayer first claimed a deduction.

§ 1.1311(a)-2 Purpose and Scope of Section 1311.—(a) Section 1311 provides for the correction of the effect of certain errors under circumstances specified in section 1312 when one or more provisions of law, such as the statute of limitations, would otherwise prevent such correction. Section 1311 may be applied to correct the effect of certain errors if, on the date of a determination (as defined in section 1313(a) and the regulations thereunder), correction is prevented by the operation of any provision of law other than sections 1311 through 1315 and section 7122 (relating to compromises) and the corresponding provisions of prior revenue laws. Examples of provisions preventing such corrections are sections 6501, 6511, 6532, and 6901 (c), (d) and (e), relating to periods of limitations; section 6212(c) and 6512 relating to the effect of petition to the Tax Court of the United States on further deficiency letters and on credits or refunds; section 7121 relating to closing agreements; and sections 6401 and 6514 relating to payments, refunds, or credits after the period of limitations has

expired. Section 1311 may also be applied to correct the effect of an error if, on the date of the determination, correction of the error is prevented by the operation of any rule of law, such as *res judicata* or *estoppel*.

(b) The determination (including a determination under section 1313(a)(4)) may be with respect to any of the taxes imposed by subtitle A of the Internal Revenue Code of 1954, by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code of 1939, or by the corresponding provisions of any prior revenue act, or by more than one of such provisions. Section 1311 may be applied to correct the effect of the error only as to the tax or taxes with respect to which the error was made which correspond to the tax or taxes with respect to which the determination relates. Thus, if the determination relates to a tax imposed by chapter 1 of the Internal Revenue Code of 1954, the adjustment may be only with respect to the tax imposed by such chapter or by the corresponding provisions of prior law.

(c) Section 1311 is not applicable if, on the date of the determination, correction of the effect of the error is permissible without recourse to said section.

(d) If the tax liability for the year with respect to which the error was made has been compromised under section 7122 or the corresponding provisions of prior revenue laws, no adjustment may be made under section 1311 with respect to said year.

(e) No adjustment may be made under section 1311 for any taxable year beginning prior to January 1, 1932. See section 1314(d).

(f) Section 1311 applies only to a determination (as defined in section 1313(a) and §§ 1.1313(a)-1 to 1.1313(a)-4, inclusive) made after November 14, 1954. Section 3801 of the Internal Revenue Code of 1939 and the regulations thereunder apply to determinations, as defined therein, made on or before November 14, 1954. See section 1315.

§ 1.1311(b) STATUTORY PROVISIONS; CORRECTION OF ERROR; CONDITIONS NECESSARY FOR ADJUSTMENT.

SEC. 1311. CORRECTION OF ERROR. * * *

(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.

§ 1.1311(b)-1 MAINTENANCE OF AN INCONSISTENT POSITION.—(a) *In general.*—Under the circumstances stated in § 1.1312–1, § 1.1312–2, paragraph (a) of § 1.1312–3, § 1.1312–5, and § 1.1312–6, the maintenance of an inconsistent position is a condition necessary for adjustment. The requirement in such circumstances is that a position maintained with respect to the taxable year of the determination and which is adopted in the determination be inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, with respect to the taxable year of the error. That is, a position successfully maintained with respect to the taxable year of the determination must be inconsistent with the treatment accorded an item which was the subject of an error in the computation of the tax for the closed taxable year. Adjustments under the circumstances stated in paragraph (b) of § 1.1312–3 and in § 1.1312–4 are made without regard to the maintenance of an inconsistent position.

(b) *Adjustments resulting in refund or credit.*—(1) An adjustment under any of the circumstances stated in §§ 1.1312–1, 1.1312–5, or 1.1312–6 which would result in the allowance of a refund or credit is authorized only if (i) the Commissioner, in connection with a determination, has maintained a position which is inconsistent with the erroneous inclusion, omission, disallowance, recognition, or nonrecognition, as the case may be, in the year of the error, and (ii) such inconsistent position is adopted in the determination.

Example. A taxpayer who keeps his books on the cash method erroneously included as income on his return for 1954 an item of accrued interest. After the period of limitations on refunds for 1954 had expired, the district director, on behalf of the Commissioner, proposed an adjustment for the year 1955 on the ground that the item of interest was received in 1955 and, therefore, was properly includible in gross income for that year. The taxpayer and the district

director entered into an agreement which meets all of the requirements of § 1.1313(a)–4 and which determines that the interest item was includible in gross income for 1955. The Commissioner has maintained a position inconsistent with the inclusion of the interest item for 1954. As the determination (the agreement pursuant to § 1.1313(a)–4) adopted such inconsistent position, an adjustment is authorized for the year 1954.

(2) An adjustment under circumstances stated in §§ 1.1312–1, 1.1312–5, or 1.1312–6 which would result in the allowance of a refund or credit is not authorized if the taxpayer with respect to whom the determination is made, and not the Commissioner, has maintained such inconsistent position.

Example. In the example in subparagraph (1) of this paragraph, assume that the Commissioner asserted a deficiency for 1955 based upon other items for that year but, in computing the net income upon which such deficiency was based, did not include the item of interest. The taxpayer appealed to the Tax Court and in his petition asserted that the interest item should be included in gross income for 1955. The Tax Court in 1960 included the item of interest in its redetermination of tax for the year 1955. In such case no adjustment would be authorized for 1954 as the taxpayer, and not the Commissioner, maintained a position inconsistent with the erroneous inclusion of the item of interest in the gross income of the taxpayer for that year.

(c) *Adjustments resulting in additional assessments.*—(1) An adjustment under any of the circumstances stated in §§ 1.1312–2, 1.1312–3(a), 1.1312–5, or 1.1312–6, which would result in an additional assessment is authorized only if (i) the taxpayer with respect to whom the determination is made has, in connection therewith, maintained a position which is inconsistent with the erroneous exclusion, omission, allowance, recognition, or nonrecognition, as the case may be in the year of the error, and (ii) such inconsistent position is adopted in the determination.

Example. A taxpayer in his return for 1950 claimed and was allowed a deduction for a loss arising from a casualty. After the taxpayer had filed his return for 1951 and after the period of limitations upon the assessment of a deficiency for 1950 had expired, it was discovered that the loss actually occurred in 1951. The taxpayer, therefore, filed a claim for refund for the year 1951 based upon the allowance of a deduction for the loss in that year, and the claim was allowed by the Commissioner in 1955. The taxpayer thus has maintained a position inconsistent with the allowance of the deduction for 1950 by filing a claim for refund for 1951 based upon the same deduction. As the determination (the allowance of the claim for refund) adopts such inconsistent position, an adjustment is authorized for the year 1950.

(2) An adjustment under the circumstances stated in §§ 1.1312–2, 1.1312–3(a), 1.1312–5, or 1.1312–6 which would result in an additional assessment is not authorized if the Commissioner, and not the taxpayer, has maintained such inconsistent position.

Example. In the example in subparagraph (1) of this paragraph, assume that the taxpayer did not file a claim for refund for 1951 but the Commissioner issued a notice of deficiency for 1951 based upon other items. The taxpayer filed a petition with the Tax Court

of the United States and the Commissioner in his answer voluntarily proposed the allowance for 1951 of a deduction for the loss previously allowed for 1950. The Tax Court took the deduction into account in its redetermination in 1955 of the tax for the year 1951. In such case no adjustment would be authorized for the year 1950 as the Commissioner, and not the taxpayer, has maintained a position inconsistent with the allowance of a deduction for the loss in that year.

§ 1.1311(b)–2 Correction Not Barred at Time of Erroneous Action.—(a) An adjustment under the circumstances stated in paragraph (b) of § 1.1312–3 (relating to the double exclusion of an item of gross income) which would result in an additional assessment, is authorized only if assessment of a deficiency against the taxpayer or related taxpayer for the taxable year in which the item is includible was not barred by any law or rule of law at the time the Commissioner first maintained, in a notice of deficiency sent pursuant to section 6212 (or section 272(a) of the Internal Revenue Code of 1939) or before the Tax Court of the United Staes, that the item described in paragraph (b) of § 1.1312–3 should be included in the gross income of the taxpayer in the taxable year to which the determination relates.

(b) An adjustment under the circumstances stated in § 1.1312–4 (relating to the double disallowance of a deduction or credit), which would result in the allowance of a credit or refund is authorized only if a credit or refund to the taxpayer or related taxpayer, attributable to such adjustment, was not barred by any law or rule of law when the taxpayer first maintained in writing before the Commissioner or the Tax Court that he was entitled to such deduction or credit for the taxable year to which the determination relates. The taxpayer will be considered to have first maintained in writing before the Commissioner or the Tax Court that he was entitled to such deduction or credit when he first formally asserts his right to such deduction or credit as, for example, in a return, in a claim for refund, or in a petition (or an amended petition) before the Tax Court.

(c) Under the circumstances of adjustment with respect to which the conditions stated in this section are applicable, the conditions stated in § 1.1311(b)–1 (maintenance of an inconsistent position) are not required. See § 1.1312–3(b) and § 1.1312–4 for examples of the application of this section.

§ 1.1311(b)–3 Existence of Relationship in Case of Adjustment by Way of Deficiency Assessment. (a) Except for cases described in § 1.1312–3(b), no adjustment by way of a deficiency assessment shall be made, with respect to a related taxpayer, unless the relationship existed both at some time during the taxable year with respect to which the error was made and at the time the taxpayer with respect to whom the determination is made first maintained the inconsistent position with respect to the taxable year to which the determination relates. In the case of an adjustment by way of a deficiency assessment under the circumstance described in § 1.1312–3(b) (where the maintenance of an inconsistent position is not required), the relationship need exist only at some time during the taxable year in which the error was made.

(b) If the inconsistent position is maintained in a return, claim for refund, or petition (or amended petition) to the Tax Court of the United States for the taxable year in respect to which the determination is made, the requisite relationship must exist on the date of filing

such document. If the inconsistent position is maintained in more than one of such documents, the requisite date is the date of filing of the document in which it was first maintained. If the inconsistent position was not thus maintained, then the relationship must exist on the date of the determination as, for example, where at the instance of the taxpayer a deduction is allowed, the right to which was not asserted in a return, claim for refund, or petition to the Tax Court, and a determination is effected by means of a closing agreement or an agreement under section 1313(a)(4).

§ 1.1312 STATUTORY PROVISIONS; CIRCUMSTANCES OF ADJUSTMENT.

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.

§ 1.1312–1 Double Inclusion of an Item of Gross Income.—(a) Paragraph (1) of section 1312 applies if the determination requires the inclusion in a taxpayer's gross income of an item which was erroneously included in the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

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

Example (1). A taxpayer who keeps his books on the cash method erroneously included in income on his return for 1947 an item of accrued rent. In 1952, after the period of limitation on refunds for 1947 had expired, the Commissioner discovered that the taxpayer received this rent in 1948 and asserted a deficiency for the year 1948 which is sustained by the Tax Court of the United States in 1955. An adjustment in favor of the taxpayer is authorized with respect to the year 1947. If the taxpayer had returned the rent for both 1947 and 1948 and by a determination was denied a refund claim for 1948 on account of the rent item, a similar adjustment is authorized.

Example (2). A husband assigned to his wife salary to be earned by him in the year 1952. The wife included such salary in her separate return for that year and the husband omitted it. The Commissioner asserted a deficiency against the wife for 1952 with respect to a different item; she contested that deficiency, and the Tax Court entered an order in her case which became final in 1955. The wife would therefore be barred by section 6512(a) from claiming a refund for 1952. Thereafter, the Commissioner asserted a deficiency against the husband on account of the omission of such salary from his return for 1952. In 1955 the husband and the Commissioner enter into a closing agreement for the year 1952 in which the salary is taxed to the husband. An adjustment is authorized with respect to the wife's tax for 1952.

§ 1.1312–2 Double Allowance of a Deduction or Credit.—(a) Paragraph (2) of section 1312 applies if the determination allows the taxpayer a deduction or credit which was erroneously allowed the same taxpayer for another taxable year or a related taxpayer for the same or another taxable year.

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

Example (1). A taxpayer in his return for 1950 claimed and was allowed a deduction for destruction of timber by a forest fire. Subsequently, it was discovered that the forest fire occurred in 1951 rather than 1950. After the expiration of the period of limitations for the assessment of a deficiency for 1950, the taxpayer filed a claim for refund for 1951 based upon a deduction for the fire loss in that year. The Commissioner in 1955 allows the claim for refund. An adjustment is authorized with respect to the year 1950.

Example (2). The beneficiary of a testamentary trust in his return for 1949 claimed, and was allowed, a deduction for depreciation of the trust property. The Commissioner asserted a deficiency against the beneficiary for 1949 with respect to a different item and a final decision of the Tax Court of the United States was rendered in 1951, so that the Commissioner was thereafter barred by section 272(f) of the Internal Revenue Code of 1939 from asserting a further deficiency against the beneficiary for 1949. The trustee thereafter filed a timely refund claim contending that, under the terms of the will, the trust, and not the beneficiary, was entitled to the allowance for depreciation. The court in 1955 sustains the refund claim. An adjustment is authorized with respect to the beneficiary's tax for 1949.

§ 1.1312–3 Double Exclusion of an Item of Gross Income.—(a) *Items included in income or with respect to which a tax was paid.*—(1) Paragraph (3)(A) of section 1312 applies if the determination requires the exclusion, from a taxpayer's 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 same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

(2) The application of paragraph (a)(1) of this section may be illustrated by the following examples:

Example (1). (i) A taxpayer received payments in 1951 under a contract for the performance of services and included the payments in his return for that year. After the expiration of the period of limitations for the assessment of a deficiency for 1950, the Commissioner issued a notice of deficiency to the taxpayer for the year 1951 based upon adjustments to other items, and the taxpayer filed a petition with the Tax Court of the United States and maintained in the proceeding before the Tax Court that he kept his books on the accrual basis and that the payments received in 1951 were on income that had accrued and was properly taxable in 1950. A final decision of the Tax Court was rendered in 1955

excluding the payments from 1951 income. An adjustment in favor of the Commissioner is authorized with respect to the year 1950, whether or not a tax had been paid on the income reported in the 1951 return.

(ii) Assume the same facts as in (i) except that the taxpayer had not included the payments in any return and had not paid a tax thereon. No adjustment would be authorized under section 1312(3)(A) with respect to the year 1950. If the taxpayer, however, had paid a deficiency asserted for 1951 based upon the inclusion of the payments in 1951 income and thereafter successfully sued for refund thereof, an adjustment would be authorized with respect to the year 1950. (See paragraph (b) of this section for circumstances under which correction is authorized with respect to items not included in income and on which a tax was not paid.)

Example (2). A father and son conducted a partnership business, each being entitled to one-half of the net profits. The father included the entire net income of the partnership in his return for 1948, and the son included no portion of this income in his return for that year. Shortly before the expiration of the period of limitations with respect to deficiency assessments and refund claims for both father and son for 1948, the father filed a claim for refund of that portion of his 1948 tax attributable to the half of the partnership income which should have been included in the son's return. The court sustains the claim for refund in 1955. An adjustment is authorized with respect to the son's tax for 1948.

(b) *Items not included in income and with respect to which the tax was not paid.*—(1) Paragraph (3)(B) of section 1312 applies if 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 a tax was not paid, but which is includible in the gross income of the same taxpayer for another taxable year, or in the gross income of a related taxpayer for the same or another taxable year. This is one of the two circumstances in which the maintenance of an inconsistent position is not a requirement for an adjustment, but the requirements of § 1.1311(b)–2 (a) must be fulfilled (correction not barred at time of erroneous action).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). The taxpayer, A, who computes his income by use of the accrual method of accounting, performed in 1949 services for which he received payments in 1949 and 1950. He did not include in his return for either 1949 or 1950 the payments which he received in 1950, and he paid no tax with respect to such payments. In 1952 the Commissioner sent a notice of deficiency to A with respect to the year 1949, contending that A should have included all of such payments in his return for that year. A contested the deficiency on the basis that in 1949 he had no accruable right to the payments which he received in 1950. In 1955 (after the expiration of the period of limitations for assessing deficiencies with respect to 1950), the Tax Court sustains A's position. The Commissioner may assess a deficiency for 1950,

since a deficiency assessment for that year was not barred when he sent the notice of deficiency with respect to 1949.

Example (2). B and C were partners in 1950, each being entitled to one-half of the profits of the partnership business. During 1950, B received an item of income which he treated as partnership income so that his return for that year reflected only 50 percent of such income. C, however, included no part of such item in any return and paid no tax with respect thereto. In 1952, the Commissioner sent to C a notice of deficiency with respect to 1950, contending that his return for that year should have reflected 50 percent of such item. C contested the deficiency on the basis that such item was not partnership income. In 1955, after the expiration of the period of limitations for assessing deficiencies with respect to 1950, the Tax Court sustained C's position. The Commissioner may assess a deficiency against B with respect to 1950 requiring him to include the entire amount of such item in his income since assessment of the deficiency was not barred when the Commissioner sent the notice of deficiency with respect to such item to C.

§ 1.1312–4 Double Disallowance of a Deduction or Credit.—(a) Paragraph (4) of section 1312 applies if the determination disallows a deduction or credit which should have been, but was not, allowed to the same taxpayer for another taxable year or to a related taxpayer for the same or another taxable year. This is one of the two circumstances in which the maintenance of an inconsistent position is not a requirement for an adjustment but the requirements of § 1.1311(b)–2(b) must be fulfilled (correction not barred at time of erroneous action).

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

Example (1). The taxpayer, A, who computes his income by use of the accrual method of accounting, deducted in his return for the taxable year 1951 an item of expense which he paid in such year. At the time A filed his return for 1951, the statute of limitations for 1950 had not expired. Subsequently, the Commissioner asserted a deficiency for 1951 based on the position that the liability for such expense should have been accrued for the taxable year 1950. In 1955, after the period of limitations on refunds for 1950 had expired, there was a determination by the Tax Court disallowing such deduction for the taxable year 1951. A is entitled to an adjustment for the taxable year 1950. However, if such liability should have been accrued for the taxable year 1946 instead of 1950, A would not be entitled to an adjustment, if a credit or refund with respect to 1946 was already barred when he deducted such expense for the taxable year 1951.

Example (2). The taxpayer, B, in his return for 1951 claimed a deduction for a charitable contribution. The Commissioner asserted a deficiency for such year contending that 50 percent of the deduction should be disallowed, since the contribution was made from community property 50 percent of which was attributable to B's spouse. The deficiency is sustained by the Tax Court in 1956, subsequent to the period of limitations within which B's spouse could claim a refund with respect to 1951. An adjustment

is permitted to B's spouse, a related taxpayer, since a refund attributable to a deduction by her of such contribution was not barred when B claimed the deduction.

§ 1.1312–5 Correlative Deductions and Inclusions for Trusts or Estates and Legatees, Beneficiaries, or Heirs.—(a) Paragraph (5) of section 1312 applies to distributions by a trust or an estate to the beneficiaries, heirs, or legatees. If the determination relates to the amount of the deduction allowed by sections 651 and 661 or the inclusion in taxable income of the beneficiary required by sections 652 and 662 (including amounts falling within subpart D of subchapter J, relating to treatment of excess distributions by trusts), or if the determination relates to the additional deduction (or inclusion) specified in section 162 (b) and (c) of the Internal Revenue Code of 1939 (or the corresponding provisions of a prior revenue act), with respect to amounts paid, credited, or required to be distributed to the beneficiaries, heirs, and legatees, and such determination requires:

(1) The allowance to the estate or trust of the deduction when such amounts have been erroneously omitted or excluded from the income of the beneficiaries, heirs, or legatees; or

(2) The inclusion of such amounts in the income of the beneficiaries, heirs, or legatees when the deduction has been erroneously disallowed to or omitted by the estate or trust; or

(3) The disallowance to an estate or trust of the deduction when such amounts have been erroneously included in the income of the beneficiaries, heirs, or legatees; or

(4) The exclusion of such amounts from the income of the beneficiaries, heirs, or legatees when the deduction has been erroneously allowed to the estate or trust.

(b) The application of paragraph (a) (1) of this section may be illustrated by the following example:

Example. For the taxable year 1954, a trustee, directed by the trust instrument to accumulate the trust income, made no distribution to the beneficiary and returned the entire income as taxable to the trust. Accordingly, the beneficiary did not include the trust income in his return for the year 1954. In 1957, a State court holds invalid the clause directing accumulation and determines that the income is required to be currently distributed. It also rules that certain extraordinary dividends which the trustee in good faith allocated to corpus in 1954 were properly allocable to income. In 1958, the trustee, relying upon the court decision, files a claim for refund of the tax paid on behalf of the trust for the year 1954 and thereafter files a suit in the District Court. The claim is sustained by the court (except as to the tax on the extraordinary dividends) in 1959 after the expiration of the period of limitations upon deficiency assessments against the beneficiary for the year 1954. An adjustment is authorized with respect to the beneficiary's tax for the year 1954. The treatment of the distribution to the beneficiary of the extraordinary dividends shall be determined under subpart D of subchapter J.

(c) The application of paragraph (a) (2) of this section may be illustrated by the following example:

Example. Assume the same facts as in the example in paragraph (b) of this section, except that, instead of the trustee's filing a refund claim, the Commissioner, relying upon the decision of the State court, asserts a deficiency against the beneficiary for 1954. The deficiency is sustained by final decision of the Tax Court of the United States in 1959, after the expiration of the period for filing claim for refund on behalf of the trust for 1954. An adjustment is authorized with respect to the trust for the year 1954.

(d) The application of paragraph (a)(3) of this section may be illustrated by the following example:

Example. A trustee claimed in the trust return for 1954 for amounts paid to the beneficiary a deduction to the extent of distributable net income. This amount was included by the beneficiary in gross income in his return for 1954. In computing distributable net income the trustee had included short and long-term capital gains. In 1958, the Commissioner asserts a deficiency against the trust on the ground that the capital gains were not includible in distributable net income, and that, therefore, the gains were taxable to the trust, not the beneficiary. The deficiency is sustained by a final decision of the Tax Court in 1960, after the expiration of the period for filing claims for refund by the beneficiary for 1954. An adjustment is authorized with respect to the beneficiary's tax for the year 1954, based on the exclusion from 1954 gross income of the capital gains previously considered distributed by the trust under section 662.

(e) The application of paragraph (a)(4) of this section may be illustrated by the following example:

Example. Assume the same facts as in the example in paragraph (d) of this section, except that, instead of the Commissioner's asserting a deficiency, the beneficiary filed a refund claim for 1954 on the same ground. The claim is sustained by the court in 1960 after the expiration of the period of limitations upon deficiency assessments against the trust for 1954. An adjustment is authorized with respect to the trust for the year 1954.

§ 1.1312-6 Basis of Property After Erroneous Treatment of a Prior Transaction.—(a) Paragraph (6) of section 1312 applies if the determination establishes the basis of property, and there occurred one of the following types of errors in respect of a prior transaction upon which such basis depends, or in respect of a prior transaction which was erroneously treated as affecting such basis:

(1) An erroneous inclusion in, or omission from, gross income, or

(2) An erroneous recognition or nonrecognition of gain or loss, or

(3) An erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible.

(b) For this section to apply, the taxpayer with respect to whom the erroneous treatment occurred must be—

(1) The taxpayer with respect to whom the determination is made, or

(2) A taxpayer who acquired title to the property in the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title in such a manner that he will have a basis ascertained by reference to the basis in the hands of the taxpayer who acquired title to the property in the erroneously treated transaction, or

(3) A taxpayer who had title to the property at the time of the erroneously treated 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).

No adjustment is authorized with respect to the transferor of the property in a transaction upon which the basis of the property depends, when the determination is with respect to the original transferee or a subsequent transferee of such original transferee.

(c) The application of this section may be illustrated by the following examples:

Example (1). In 1949 taxpayer A transferred property which had cost him $5,000 to the X Corporation in exchange for an original issue of shares of its stock having a fair market value of $10,000. In his return for 1949 taxpayer A treated the exchange as one in which the gain or loss was not recognizable:

(i) In 1955 the X Corporation maintains that the gain should have been recognized in the exchange in 1949 and therefore the property it received had a $10,000 basis for depreciation. Its position is adopted in a closing agreement. No adjustment is authorized with respect to the tax of the X Corporation for 1949, as none of the three types of errors specified in paragraph (a) of this section occurred with respect to the X Corporation in the treatment of the exchange in 1949. Moreover, no adjustment is authorized with respect to taxpayer A, as he is not within any of the three classes of taxpayers described in paragraph (b) of this section.

(ii) In 1953 taxpayer A sells the stock which he received in 1949 and maintains that, as gain should have been recognized in the exchange in 1949, the basis for computing the profit on the sale is $10,000. His position is confirmed in a closing agreement executed in 1955. An adjustment is authorized with respect to his tax for the year 1949 as the basis for computing the gain on the sale depends upon the transaction in 1949, and in respect of that transaction there was an erroneous nonrecognition of gain to taxpayer A, the taxpayer with respect to whom the determination is made.

Example (2). In 1950 taxpayer A was the owner of 10 shares of the common stock of the Z Corporation which had a basis of $1,500. In that year he received as a dividend thereon 10 shares of the preferred stock of the same corporation having a fair market value of $1,000. On his books, entries were made

reducing the basis of the common stock by allocating $500 of the basis to the preferred stock, and on his return for 1950 he did not include the dividend in gross income.

(i) In 1951 taxpayer A made a gift of the preferred stock of the Z Corporation to taxpayer B, an unrelated individual. Taxpayer B sold the stock in 1953 and on his return for that year he reported the sale and claimed a basis of $1,000, contending that the dividend of preferred stock was taxable to A in 1950 at its fair market value of $1,000. The basis of $1,000 is confirmed by a closing agreement executed in 1955. An adjustment is authorized with respect to taxpayer A's tax for 1950, as the closing agreement determines basis of property, and in a prior transaction upon which such basis depends there was an erroneous omission from gross income of taxpayer A, a taxpayer who acquired title to the property in the erroneously treated transaction and from whom, immediately, the taxpayer with respect to whom the determination is made derived title.

(ii) Assuming the same facts as in (i) except that the common stock instead of the preferred stock was the subject of the gift, and the basis claimed by taxpayer B and confirmed in the closing agreement was $1,500. An adjustment is authorized with respect to taxpayers A's tax for 1950, as the closing agreement determines the basis of property, and in a prior transaction which was erroneously treated as affecting such basis there was an erroneous omission from gross income of taxpayer A, a taxpayer who had title to the property at the time of the erroneously treated transaction, and from whom, immediately, taxpayer B, with respect to whom the determination is made, derived title. The basis of the property in taxpayer B's hands with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift).

Example (3). In 1950 taxpayer A sold property acquired at a cost of $5,000 to taxpayer B for $10,000. In his return for 1950 taxpayer A failed to include the profit on such sale. In 1953 taxpayer B sold the property for $12,000, and in his return for 1953 reported a gain of $2,000 upon the sale, which is confirmed by a closing agreement executed in 1955. No adjustment is authorized with respect to the tax of taxpayer A for 1950, as he does not come within any of the three classes of taxpayers described in paragraph (b) of this section.

Example (4). In 1950 a taxpayer who owned 100 shares of stock in Corporation Y received $1,000 from the corporation which amount the taxpayer reported on his return for 1950 as a taxable dividend. In 1952 Corporation Y was completely liquidated and the taxpayer received in that year liquidating distributions totalling $8,000. In his return for 1952 the taxpayer reported the receipt of the $8,000 and computed his gain or loss upon the liquidation by using as a basis the amount which he paid for the stock. The Commissioner maintained that the distribution in 1950 was a distribution out of capital and that in computing the taxpayer's gain or loss upon the liquidation in 1952, the basis of the stock should be reduced by the $1,000. This position is adopted in a closing agreement executed in 1955 with respect to

the year 1952. An adjustment is authorized with respect to the year 1950 as the basis for computing gain or loss in 1952 depends upon the transaction in 1950, and in respect of the 1950 transaction (upon which the basis of the property depends) there was an erroneous inclusion in gross income of the taxpayer with respect to whom the determination is made.

Example (5). In 1946 a taxpayer received 100 shares of stock of the X Corporation having a fair market value of $5,000, in exchange for shares of stock in the Y Corporation which he had acquired at a cost of $12,000. In his return for 1946 the taxpayer treated the exchange as one in which gain or loss was not recognizable. The taxpayer sold 50 shares of the X Corporation stock in 1947 and in his return for that year treated such shares as having a $6,000 basis. In 1952, the taxpayer sold the remaining 50 shares of stock of the X Corporation for $7,500 and reported $1,500 gain in his return for 1952. After the expiration of the period of limitations on deficiency assessments and on refund claims for 1946 and 1947, the Commissioner asserted a deficiency for 1952 on the ground that the loss realized on the exchange in 1946 was erroneously treated as nonrecognizable, and the basis for computing gain upon the sale in 1952 was $2,500, resulting in a gain of $5,000. The deficiency is sustained by the Tax Court in 1955. An adjustment is authorized with respect to the year 1946 as to the entire $7,000 loss realized on the exchange, as the Court's decision determines the basis of property, and in a prior transaction upon which such basis depends there was an erroneous nonrecognition of loss to the taxpayer with respect to whom the determination was made. No adjustment is authorized with respect to the year 1947 as the basis for computing gain upon the sale of the 50 shares in 1952 does not depend upon the transaction in 1947 but upon the transaction in 1946.

§ 1.1312–7 Law Applicable in Determination of Error.—The question whether there was an erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition is determined under the provisions of the internal revenue laws applicable with respect to the year as to which the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was made. The fact that the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was in pursuance of an interpretation, either judicial or administrative, accorded such provisions of the internal revenue laws at the time of such action is not necessarily determinative of this question. For example, if a later judicial decision authoritatively alters such interpretation so that such action was contrary to such provisions of the internal revenue laws as later interpreted, the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, is erroneous within the meaning of section 1312.

§ 1.1313(a) Statutory Provisions; Definition of Determination.

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.

§ 1.1313(a)-1 Decision by Tax Court or Other Court as a Determination.—(a) A determination may take the form of a decision by the Tax Court of the United States or a judgment, decree, or other order by any court of competent jurisdiction, which has become final.

(b) The date upon which a decision by the Tax Court becomes final is prescribed in section 7481.

(c) The date upon which a judgment of any other court becomes final must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

§ 1.1313(a)-2 Closing Agreement as a Determination.—A determination may take the form of a closing agreement authorized by section 7121. Such an agreement may relate to the total tax liability of the taxpayer for a particular taxable year or years or to one or more separate items affecting such liability. A closing agreement becomes final for the purpose of this section on the date of its approval by the Commissioner.

§ 1.1313(a)-3 Final Disposition of Claim for Refund as a Determination.—(a) *In general.*—A determination may take the form of a final disposition of a claim for refund. Such disposition may result in a determination with respect to two classes of items, i. e., items included by the taxpayer in a claim for refund and items applied by the Commissioner to offset the alleged overpayment. The time at which a disposition in respect of a particular item becomes final may depend not only upon what action is taken with respect to that item but also upon whether the claim for refund is allowed or disallowed.

(b) *Items with respect to which the taxpayer's claim is allowed.*—(1) The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is sustained becomes final on the date of allowance of the refund or credit if—

(i) The taxpayer's claim for refund is unqualifiedly allowed; or

(ii) The taxpayer's contention with respect to an item is sustained and with respect to other items is denied, so that the net result is an allowance of refund or credit; or

(iii) The taxpayer's contention with respect to an item is sustained, but the Commissioner applies other items to offset the amount of the alleged overpayment and the items so applied do not completely offset such amount but merely reduce it so that the net result is an allowance of refund or credit.

(2) If the taxpayer's contention in the claim for refund with respect to an item is sustained but the Commissioner applies other items to offset the amount of the alleged overpayment so that the net result is a disallowance of the claim for refund, the date of mailing, by registered mail, of the notice of disallowance (see section 6532) is the date of the final disposition as to the item with respect to which the taxpayer's contention is sustained.

(c) *Items with respect to which the taxpayer's claim is disallowed.*—The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is denied becomes final upon the expiration of the time allowed by section 6532 for instituting suit on the claim for refund, unless the suit is instituted prior to the expiration of such period, if—

(1) The taxpayer's claim for refund is unqualifiedly disallowed; or

(2) The taxpayer's contention with respect to an item is denied and with respect to other items is sustained so that the net result is an allowance of refund or credit; or

(3) The taxpayer's contention with respect to an item is sustained in part and denied in part. For example, assume that the taxpayer claimed a deductible loss of $10,000 and a consequent overpayment of $2,500 and the Commissioner concedes that a deductible loss was sustained, but only in the amount of $5,000. The disposition of the claim for refund with respect to the allowance of the $5,000 and the disallowance of the remaining $5,000 becomes final upon the expiration of the time for instituting suit on the claim for refund unless suit is instituted prior to the expiration of such period.

(d) *Items applied by the Commissioner in reduction of the refund or credit.*—If the Commissioner applies an item in reduction of the overpayment alleged in the claim for refund, and the net result is an allowance of refund or credit, the disposition with respect to the item so applied by the Commissioner becomes final upon the expiration of the time allowed by section 6532 for instituting suit on the claim for refund, unless suit is instituted prior to the expiration of such period. If such application of the item results in the assertion of a deficiency, such action does not constitute a final disposition of a claim for refund within the meaning of § 1.1313(a)–3, but subsequent action taken with respect to such deficiency may result in a determination under § 1.1313(a)–1, 2, or 4.

(e) *Elimination of waiting period.*—The necessity of waiting for the expiration of the 2-year period of limitations provided in section 6532 may be avoided in such cases as are described in paragraph (c)

or (d) of this section by the use of a closing agreement (see § 1.1313 (a)–2) or agreement under § 1.1313(a)–4 to effect a determination.

§ 1.1313(a)–4 AGREEMENT PURSUANT TO SECTION 1313(a)(4) AS A DETERMINATION.—(a) *In general.*—(1) A determination may take the form of an agreement made pursuant to this section. This section is intended to provide an expeditious method for obtaining an adjustment under section 1311 and for offsetting deficiencies and refunds whenever possible. The provisions of sections 1311 through 1315 must be strictly complied with in any such agreement.

(2) An agreement made pursuant to this section will not, in itself, establish the tax liability for the open taxable year to which it relates, but it will state the amount of the tax, as then determined, for such open year. The tax may be the amount of tax shown on the return as filed by the taxpayer, but if any changes in the amount have been made, or if any are being made by documents executed concurrently with the execution of said agreement, such changes must be taken into account. For example, an agreement pursuant to this section may be executed concurrently with the execution of a waiver of restrictions on assessment and collection of a deficiency or acceptance of an overassessment with respect to the open taxable year, or concurrently with the execution and filing of a stipulation in a proceeding before the Tax Court of the United States, where an item which is to be the subject of an adjustment under section 1311 is disposed of by the stipulation and is not left for determination by the court.

(b) *Contents of agreement.*—An agreement made pursuant to this section shall be so designated in the heading of the agreement, and it shall contain the following:

(1) A statement of the amount of the tax determined for the open taxable year to which the agreement relates, and if said liability is established or altered by a document executed concurrently with the execution of the agreement, a reference to said document.

(2) A concise statement of the material facts with respect to the item that was the subject of the error in the closed taxable year or years, and a statement of the manner in which such item was treated in computing the tax liability set forth pursuant to subparagraph (1) of this paragraph.

(3) A statement as to the amount of the adjustment ascertained pursuant to § 1.1314(a)–1 for the taxable year with respect to which the error was made and, where applicable, a statement as to the amount of the adjustment or adjustments ascertained pursuant to § 1.1314(a)–2 with respect to any other taxable year or years; and

(4) A waiver of restrictions on assessment and collection of any deficiencies set forth pursuant to subparagraph 3 of this paragraph.

(c) *Execution and effect of agreement.*—An agreement made pursuant to this section shall be signed by the taxpayer with respect to whom the determination is made, or on the taxpayer's behalf by an agent or attorney acting pursuant to a power of attorney on file with the Internal Revenue Service. If an adjustment is to be made in a case of a related taxpayer, the agreement shall be signed also by the

related taxpayer, or on the related taxpayer's behalf by an agent or attorney acting pursuant to a power of attorney on file with the Internal Revenue Service. It may be signed on behalf of the Commissioner by the district director, or such other person as is authorized by the Commissioner. When duly executed, such agreement will constitute the authority for an allowance of any refund or credit agreed to therein, and for the immediate assessment of any deficiency agreed to therein for the taxable year with respect to which the error was made, or any closed taxable year or years affected, or treated as affected, by a net operating loss deduction or capital loss carryover determined with reference to the taxable year with respect to which the error was made.

(d) *Finality of determination.*—A determination made by an agreement pursuant to this section becomes final when the tax liability for the open taxable year to which the determination relates becomes final. During the period, if any, that a deficiency may be assessed or a refund or credit allowed with respect to such year, either the taxpayer or the Commissioner may properly pursue any of the procedures provided by law to secure a further modification of the tax liability for such year. For example, if the taxpayer subsequently files a claim for refund, or if the Commissioner subsequently issues a notice of deficiency with respect to such year, either may adopt a position with respect to the item that was the subject of the adjustment that is at variance with the manner in which said item was treated in the agreement. Any assessment, refund, or credit that is subsequently made with respect to the tax liability for such open taxable year, to the extent that it is based upon a revision in the treatment of the item that was the subject of the adjustment, shall constitute an alteration or revocation of the determination for the purpose of a redetermination of the adjustment pursuant to § 1.1314(b)–1(d).

§ 1.1313(b)–(c) STATUTORY PROVISIONS; DEFINITIONS OF TAXPAYER AND RELATED TAXPAYER.

SEC. 1313. DEFINITIONS. * * *

(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).

§ 1.1313(c)–1 RELATED TAXPAYER.—An adjustment in the case of the taxpayer with respect to whom the error was made may be authorized under section 1311 although the determination is made with respect to a different taxpayer, provided that such taxpayers stand in one of the relationships specified in section 1313(c). The concept of "related taxpayer" has application to all of the circumstances of

adjustment specified in § 1.1312–1 through § 1.1312–5; it does not apply in the circumstances specified in § 1.1312–6. If such relationship exists, it is not essential that the error involve a transaction made possible only by reason of the existence of the relationship. For example, if the error with respect to which an adjustment is sought under section 1311 grew out of an assignment of rents between taxpayer A and taxpayer B, who are partners, and the determination is with respect to taxpayer A, an adjustment with respect to taxpayer B may be permissible despite the fact that the assignment had nothing to do with the business of the partnership. The relationship need not exist throughout the entire taxable year with respect to which the error was made, but only at some time during that taxable year. For example, if a taxpayer on February 15 assigns to his fiancee the net rents of a building which the taxpayer owns, and the two are married before the end of the taxable year, an adjustment may be permissible if the determination relates to such rents despite the fact that they were not husband and wife at the time of the assignment. See § 1.1311(b)–3 for the requirement in certain cases that the relationship exist at the time an inconsistent position is first maintained.

§ 1.1314(a) STATUTORY PROVISIONS; AMOUNT AND METHOD OF ADJUSTMENT; ASCERTAINMENT OF AMOUNT OF ADJUSTMENT.

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.

§ 1.1314(a)–1 ASCERTAINMENT OF AMOUNT OF ADJUSTMENT IN YEAR OF ERROR.—(a) In computing the amount of the adjustment under sections 1311 to 1315, inclusive, there must first be ascertained the amount of the tax previously determined for the taxpayer as to whom the error was made for the taxable year with respect to which the error was made. The tax previously determined for any taxable year may be the amount of tax shown on the taxpayer's return, but if

any changes in that amount have been made, they must be taken into account. In such cases, the tax previously determined will be the sum of the amount shown as the tax by the taxpayer upon his return and the amounts previously assessed (or collected without assessment) as deficiencies, reduced by the amount of any rebates made. The amount shown as the tax by the taxpayer upon his return and the amount of any rebates or deficiencies shall be determined in accordance with the provisions of section 6211 and the regulations thereunder.

(b) (1) The tax previously determined may consist of tax for any taxable year beginning after December 31, 1931, imposed by subtitle A of the Internal Revenue Code of 1954, by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code of 1939, or by the corresponding provisions of prior internal revenue laws, or by any one or more of such provisions.

(2) After the tax previously determined has been ascertained, a recomputation must then be made under the laws applicable to said taxable year to ascertain the increase or decrease in tax, if any, resulting from the correction of the error. The difference between the tax previously determined and the tax as recomputed after correction of the error will be the amount of the adjustment.

(c) No change shall be made in the treatment given any item upon which the tax previously determined was based other than in the correction of the item or items with respect to which the error was made. However, due regard shall be given to the effect that such correction may have on the computation of gross income, taxable income, and other matters under chapter 1. If the treatment of any item upon which the tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax, depends upon the amount of income (e. g., charitable contributions, foreign tax credit, dividends received credit, medical expenses, and percentage depletion), readjustment in these particulars will be necessary as part of the recomputation in conformity with the change in the amount of the income which results from the correct treatment of the item or items in respect of which the error was made.

(d) Any interest or additions to the tax collected as a result of the error shall be taken into account in determining the amount of the adjustment.

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

Example. (1) For the taxable year 1949 a taxpayer with no dependents, who kept his books on the cash receipts and disbursements method, filed a joint return with his wife disclosing adjusted gross income of $42,000, deductions amounting to $12,000, and a net income of $30,000. Included among other items in the gross income were salary in the amount of $15,000 and rents accrued but not yet received in the amount of $5,000. During the taxable year he donated $10,000 to the American Red Cross and in his return claimed a deduction of $6,300 on account thereof, representing the maximum deduction allowable under the 15-percent limitation imposed by section 23(o) of the Internal Revenue Code of 1939 as applicable to the year 1949. In computing his net income he omitted interest income amounting to $6,000 and neglected to take a deduction for interest paid in the amount

of $4,500. The return disclosed a tax liability of $7,788, which was assessed and paid. After the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1949, the Commissioner included the item of rental income amounting to $5,000 in the taxpayer's gross income for the year 1950 and asserted a deficiency for that year. As a result of a final decision of the Tax Court of the United States in 1955 sustaining the deficiency for 1950, an adjustment is authorized for the year 1949.

(2) The amount of the adjustment is computed as follows:

Tax previously determined for 1949	$7,788
Net income for 1949 upon which tax previously determined was based	30,000
Less: Rents erroneously included	5,000
Balance	25,000
Adjustment for contributions (add 15 percent of $5,000)	750
Net income as adjusted	$25,750
Tax as recomputed	6,152
Tax previously determined	7,788
Difference	1,636
Amount of adjustment to be refunded or credited	$1,636

(3) In accordance with the provisions of paragraph (c) of this section, the recomputation to determine the amount of the adjustment does not take into consideration the item of $6,000 representing interest received, which was omitted from gross income, or the item of $4,500 representing interest paid, for which no deduction was allowed.

§ 1.1314(a)–2 Adjustment to Other Barred Taxable Years.—(a) An adjustment is authorized under section 1311 with respect to a taxable year or years other than the year of the error, but only if all of the following requirements are met:

(1) The tax liability for such other year or years must be affected, or must have been 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).

(2) The net operating loss deduction or capital loss carryover must be determined with reference to the taxable year with respect to which the error was made.

(3) On the date of the determination, the adjustment with respect to such other year or years must be prevented by some law or rule of law, other than sections 1311 through 1315 and section 7122 and the corresponding provisions of prior revenue laws.

(b) The amount of the adjustment for such other year or years shall be computed in a manner similar to that provided in § 1.1314(a)–1. The tax previously determined for such other year or years shall be ascertained. A recomputation must then be made to ascertain the increase or decrease in tax, if any, resulting solely from the correction of the net operating loss deduction or capital loss carryover.

The difference between the tax previously determined and the tax as recomputed is the amount of the adjustment. In the recomputation, no consideration shall be given to items other than the following: (1) the items upon which the tax previously determined for such other year or years was based, and (2) the net operating loss deduction or capital loss carryover as corrected. In determining the correct net operating loss deduction or capital loss carryover, no changes shall be made in taxable income (net income in the case of taxable years subject to the provisions of the Internal Revenue Code of 1939 or prior revenue laws), net operating loss or capital loss, for any barred taxable year, except as provided in section 1314. Section 172 and the corresponding provisions of prior revenue laws, and the regulations promulgated thereunder, prescribe the methods for computing the net operating loss deduction. Section 1212 and the corresponding provisions of prior revenue laws, and the regulations promulgated thereunder, prescribe the methods for computing the capital loss carryover.

(c) A net operating loss deduction or a capital loss carryover determined with reference to the year of the error may affect, or may have been treated as affecting, a taxable year with respect to which an adjustment is not prevented by the operation of any law or rule of law. In such case, the appropriate adjustment shall be made with respect to such open taxable year. However, the redetermination of the tax for such open taxable year is not made pursuant to sections 1311 to 1315, inclusive, and the adjustment for such open year and the method of computation are not limited by the provisions of said sections.

(d) The application of this section may be illustrated by the following example:

Example. The taxpayer is a corporation which makes its income tax returns on a calendar year basis. Its net income in 1949, computed without any net operating loss deduction was $10,000, but because of a net operating loss deduction in excess of that amount resulting from a carryback of a net operating loss claimed for 1950, it paid no income tax for 1949. On its return for 1950 it showed an excess of deductions over gross income of $14,000, and it paid no income tax for 1950. For the year 1951 its net income, computed without any net operating loss deduction, was $15,000, and a net operating loss deduction of $13,000 was allowed ($4,000 of which was attributable to the carryover from 1950 and $9,000 of which was attributable to the carryback of a net operating loss of $9,000 sustained in 1952). In 1957 the assessment of deficiencies or the allowance of refunds for all of said years are barred by the statute of limitations.

(i) A Tax Court decision entered in 1957 with respect to the taxable year 1953 constituted a determination under which an adjustment is authorized to the taxable year 1950, the year with respect to which the error was made. This adjustment increases income for said year by $15,000, so that instead of a net operating loss of $14,000, its corrected net income is $1,000 for 1950, and the tax computed on that income will be assessed as a deficiency for 1950. An adjustment is authorized under this section with respect to each of the years 1949 and 1951, as the tax liability for

each year was treated as affected by a net operating loss deduction which was determined by a computation in which reference was made to the year 1950. In the recomputation of the tax for 1949, the net operating loss carryback from 1950 will be eliminated, and in the recomputation of the tax for 1951 the net operating loss carryover from 1950 will be eliminated; for each of the years 1949 and 1951 there will be an adjustment which will be treated as a deficiency for said year.

(ii) Assuming the same facts except that the correction with respect to the year 1950 increases the net operating loss for said year from $14,000 to $20,000. As a result of this correction, there will be no change in the tax due for 1949 and 1950. However, the net operating loss deduction for 1951 is recomputed to be $19,000, the aggregate of the $10,000 carryover from 1950 and the $9,000 carryback from 1952 (the carryover from 1950 is the excess of the $20,000 net operating loss for 1950 over the $10,000 net income for 1949, such 1949 income being determined without any net operating loss deduction). As a result of the correction of the net operating loss deduction for 1951, the tax recomputation will show no tax due for said year, and the adjustment for 1951 will result in a refund or credit of the tax previously paid. Moreover, computations resulting from this adjustment will disclose a net operating loss carryover from 1952 to 1953 of $4,000, that is, the excess of the $9,000 net operating loss for 1952 over the $5,000 net income for 1951 (such net income for 1951 being computed as the $15,000 reduced by the carryover of $10,000 from 1950, the carryback from 1952 not being taken into account). A further adjustment is authorized under section 1311 with respect to any subsequent barred year in which the tax liability is affected by a carryover of the net operating loss from 1952, inasmuch as such carryover from 1952 has been determined by a computation in which reference was made to 1950, the taxable year of the error.

§ 1.1314(b) STATUTORY PROVISIONS; AMOUNT AND METHOD OF ADJUSTMENT; METHOD OF ADJUSTMENT.

SEC. 1314. AMOUNT AND METHOD OF ADJUSTMENT. * * *

(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.

§ 1.1314(b)-1 METHOD OF ADJUSTMENT.—(a) If the amount of the adjustment ascertained pursuant to § 1.1314(a)-1 or § 1.1314(a)-2 represents an increase in tax, it is to be treated as if it were a deficiency determined by the Commissioner with respect to the taxpayer as to whom the error was made and for the taxable year or years with respect to which such adjustment was made. The amount of such adjustment is thus to be assessed and collected under the law and regulations applicable to the assessment and collection of deficiencies, subject, however, to the limitations imposed by § 1.1314(c)-1. Notice of deficiency, unless waived, must be issued with respect to such amount or amounts, and the taxpayer may contest the deficiency before the Tax Court of the United States or, if he chooses, may pay the deficiency and later file claim for refund. If the amount of the adjustment ascertained pursuant to § 1.1314(a)-1 or § 1.1314(a)-2 represents a decrease in tax, it is to be treated as if it were an overpayment claimed by the taxpayer with respect to whom the error was made for the taxable year or years with respect to which such adjustment was made. Such amount may be recovered under the law and regulations applicable to overpayments of tax, subject, however, to the limitations imposed by § 1.1314(c)-1. The taxpayer must file a claim for refund thereof, unless the overpayment is refunded without such claim, and if the claim is denied or not acted upon by the Commissioner within the prescribed time, the taxpayer may then file suit for refund.

(b) For the purpose of the adjustments authorized by section 1311, the period of limitations upon the making of an assessment or upon refund or credit, as the case may be, for the taxable year of an adjustment shall be considered as if, on the date of the determination, one year remained before the expiration of such period. The Commissioner thus has one year from the date of the determination within which to mail a notice of deficiency in respect of the amount of the adjustment where such adjustment is treated as if it were a deficiency. The issuance of such notice of deficiency, in accordance with the law and regulations applicable to the assessment of deficiencies will suspend the running of the 1-year period of limitations provided in section 1314(b). In accordance with the applicable law and regulations governing the collection of deficiencies, the period of limitation for collection of the amount of the adjustment will commence to run from the date of assessment of such amount. (See section 6502 and corresponding provisions of prior revenue laws.) Similarly, the taxpayer has a period of one year from the date of the determination within which to file a claim for refund in respect of the amount of the adjustment where such adjustment is treated as if it were an overpayment. Where the amount of the adjustment is treated as if it were a deficiency and the taxpayer chooses to pay such deficiency and contest it by way of a claim for refund, the period of limitation upon filing a claim for refund will commence to run from the date of such payment. See section 6511 and corresponding provisions of prior revenue laws.

(c) The amount of an adjustment treated as if it were a deficiency or an overpayment, as the case may be, will bear interest and be subject to additions to the tax to the extent provided by the internal revenue laws applicable to deficiencies and overpayments for the taxable year with respect to which the adjustment is made. 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.

(d) If, as a result of a determination provided for in § 1.1313(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 § 1.1314(a)–1 and § 1.1314(a)–2 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 section 1311. For the circumstances under which such an agreement can be altered or revoked, see paragraph (d) of § 1.1313(a)–4.

§ 1.1314(c) STATUTORY PROVISIONS; AMOUNT AND METHOD OF ADJUSTMENT; ADJUSTMENT UNAFFECTED BY OTHER ITEMS.

SEC. 1314. AMOUNT AND METHOD OF ADJUSTMENT. * * *

(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.

§ 1.1314(c)–1 ADJUSTMENT UNAFFECTED BY OTHER ITEMS.—(a) The amount of any adjustment ascertained under § 1.1314(a)–1 or § 1.1314(a)–2 shall not be diminished by any credit or set-off based upon any item other than the one that was the subject of the adjustment.

(b) The application of this section may be illustrated by the following examples:

Example (1). In the example set forth in paragraph (e) of § 1.1314(a)–1, if, after the amount of the adjustment had been ascertained, the taxpayer filed a refund claim for the amount thereof, the Commissioner could not diminish the amount of that claim by offsetting against it the amount of tax which should have been paid with respect to the $6,000 interest item omitted from gross income for the year 1949; nor could the court, if suit were brought on such claim for refund, offset against the amount of the adjustment the amount of tax which should have been paid with respect to such interest. Similarly, the amount of the refund could not be increased by any amount attributable to the taxpayer's failure to deduct the $4,500 interest paid in the year 1949.

Example (2). Assume that a taxpayer included in his gross income for the year 1953 an item which should have been included in his gross income for the year 1952. After the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1952, the taxpayer filed a claim for refund for the year 1953 on the ground that such item was not properly includible in gross income for that year. The claim for

refund was allowed by the Commissioner and as a result of such determination an adjustment was authorized under section 1311 with respect to the tax for 1952. If, in such case, the Commissioner issued a notice of deficiency for the amount of the adjustment and the taxpayer contested the deficiency before the Tax Court of the United States, the taxpayer could not in such proceeding claim an offset based upon his failure to take an allowable deduction for the year 1952; nor could the Tax Court in its decision offset against the amount of the adjustment any overpayment for the year 1952 resulting from the failure to take such deduction.

(c) If the Commissioner has refunded the amount of an adjustment under section 1311, the amount so refunded may not subsequently be recovered by the Commissioner in any suit for erroneous refund based upon any item other than the one that was the subject of the adjustment.

Example. In the example set forth in paragraph (e) of § 1.1314 (a)–1, if the Commissioner had refunded the amount of the adjustment, no part of the amount so refunded could subsequently be recovered by the Commissioner by a suit for erroneous refund based on the ground that there was no overpayment for 1949, as the taxpayer had failed to include in gross income the $6,000 item of interest received in that year.

(d) If the Commissioner has assessed and collected the amount of an adjustment under section 1311, no part thereof may be recovered by the taxpayer in any suit for refund based upon any item other than the one that was the subject of the adjustment.

Example. In example (2) of paragraph (b) of this section, if the taxpayer had paid the amount of the adjustment, he could not subsequently recover any part of such payment in a suit for refund based upon the failure to take an allowable deduction for the year 1952.

(e) If the amount of the adjustment is considered an overpayment, it may be credited, under applicable law and regulations, together with any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made such overpayment. Likewise, if the amount of the adjustment is considered as a deficiency, any overpayment by the taxpayer of any internal revenue tax may be credited against the amount of such adjustment in accordance with the applicable law and regulations thereunder. (See section 6402 and the corresponding provisions of prior revenue laws.) Accordingly, it may be possible in one transaction between the Commissioner and the taxpayer to settle the taxpayer's tax liability for the year with respect to which the determination is made and to make the adjustment under section 1311 for the year with respect to which the error was made or for a year which is affected, or treated as affected, by a net operating loss deduction or a capital loss carryover from the year of the error.

§ 1.1314(d)–(e) STATUTORY PROVISIONS; AMOUNT AND METHOD OF ADJUSTMENT; NO ADJUSTMENTS FOR YEARS PRIOR TO 1932; NOT APPLICABLE TO TAX IMPOSED BY SUBTITLE C.

SEC. 1314. AMOUNT AND METHOD OF 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).

§ 1.1315 STATUTORY PROVISIONS; EFFECTIVE DATE.

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.

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved February 3, 1956.

G. M. HUMPHREY,
Secretary of the Treasury.

(Filed by the Division of the Federal Register February 8, 1956, 8:47 a. m.)

PART IV.—WAR LOSS RECOVERIES

SECTION 1331.—WAR LOSS RECOVERIES

26 CFR 1.1331: Statutory provisions; war loss recoveries. T. D. 6164 [1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX: TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Regulations prescribed under subchapter Q—War loss recoveries.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

AUTHORITY: §§ 1.1331 to 1.1337, incl., issued under secs. 1333, 1335, 1336, 1337, and 7805, I. R. C. 1954; 68A Stat. 344, 346, 347, 917; 26 U. S. C. 1333, 1335, 1336, 1337, 7805.

On August 27, 1955, notice of proposed rulemaking with respect to regulations under subchapter Q, part IV (relating to war loss recoveries), of the Internal Revenue Code of 1954, was published in the Federal Register (20 F. R. 6292). After consideration of such relevant suggestions as were presented by interested persons regarding the proposals, the regulations as so published have been modified and are hereby adopted as set forth below.

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[1] The publication of this Treasury Decision in 21 F. R. 1640 dated March 15, 1956, contains (1) a series of instructions for modifying the notice of proposed rule making published in 20 F. R. 6292, dated August 27, 1955, and (2) the full context of the regulations with such modifications. As here published the Treasury Decision reflects the full context of such regulations, with modifications. The individual instructions have been omitted.

WAR LOSS RECOVERIES

§ 1.1331 STATUTORY PROVISIONS; WAR LOSS RECOVERIES

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.

§ 1.1331–1 RECOVERIES IN RESPECT OF WAR LOSSES.—(a) (1) The amount of any recovery in respect of "war loss property" must be included in gross income to the extent provided in section 1332 unless, pursuant to the taxpayer's election under section 1335, the provisions of section 1333 are applicable to such recovery. For the treatment of war loss recoveries under section 1333 and the manner of making the election under section 1335, see §§ 1.1333–1 and 1.1335–1.

(2) As used in this part, the term "war loss property" means property considered under section 127(a) of the Internal Revenue Code of 1939 as "destroyed or seized", including any interest described in section 127(a)(3) of the Internal Revenue Code of 1939.

(3) For regulations governing the treatment of war losses under the Internal Revenue Code of 1939, see §§ 29.127(a)–1 to 29.127(a)–4, inclusive, 29.127(b)–1, and 29.127(e)–1 of Regulations 111 (26 CFR (1939) Part 29) and §§ 39.127(a)–1 to 39.127(a)–4, inclusive, 39.127(b)–1, and 39.127(e)–1 of Regulations 118 (26 CFR (1939) Part 39).

(b) The recoveries in respect of any war loss property include the recovery of the same war loss property and the recovery of any money or property in lieu of such property or on account of the destruction or seizure of such property. For example, there is a recovery upon the return to the taxpayer after the termination of the war of his property which was treated as war loss property because it was located in a country at war with the United States. An award by a government on account of the seizure of the taxpayer's property by an enemy country is a recovery under this section. The amount obtained upon the sale or other transfer by the taxpayer of his right to any war loss property is also a recovery for the purpose of this section. Similarly, if a taxpayer who sustained a war loss upon the liquidation of a corporation has received the rights to any property of the corporation which was treated as war loss property, any recovery by the taxpayer with respect to such rights is a recovery by him for the purposes of this section.

(c) For the purpose of this section, the recoveries considered are only those with respect to war losses sustained in prior taxable years. Similarly, the only deductions considered are those allowable for prior taxable years, and any allowable deductions for the year of the recovery are ignored for the purposes of applying such section to the recovery.

(d) If a deduction was claimed under section 127 (a) of the Internal Revenue Code of 1939 by a taxpayer in computing his tax for any taxable year and if such deduction was disallowed in whole or in part, any recovery in respect of the portion disallowed shall not be subject to the provisions of sections 1331 through 1337.

§ 1.1332 STATUTORY PROVISIONS; INCLUSION IN GROSS INCOME OF WAR LOSS RECOVERIES.

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.

§ 1.1332–1 INCLUSION IN GROSS INCOME OF WAR LOSS RECOVERIES—(a) *Amount of recovery.*—Except as provided in section 1333 (1), the amount of the recovery in respect of a war loss in a previous taxable year is determined in the same manner for the purpose of either section 1332 or 1333. The amount of the recovery of any money or property in respect of any war loss is the aggregate of the amount of such money and of the fair market value of such property, both determined as of the date of the recovery. But see § 1.1333–1(a) for optional valuation where the taxpayer recovers the same war loss property.

(b) *Amount of gain includible.*—(1) A taxpayer who has sustained a war loss described in section 127(a) of the Internal Revenue Code of 1939 and who has not elected to have the provisions of section 1333 apply to any taxable year in which he recovered any money or property in respect of a war loss in any previous taxable year must include in his gross income for each taxable year, to the extent provided in section 1332, the amount of his recoveries of money and property for such taxable year in respect of any war loss in a previous taxable year. Section 1332 provides that such recoveries for any taxable year are not includible in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of such war losses which did not result in a reduction of any tax under chapter 1 or 2 of the Internal Revenue Code of 1939. War loss recoveries are considered as made first on account of war losses allowable but not actually allowed as a deduction, and second on account of war losses allowed as a deduction but which did not result in a reduction of tax under chapter 1 or chapter 2 of the Internal Revenue Code of 1939. If there were deductions allowed on account of war losses for two or more taxable years which did not result in a reduction of any tax under chapter 1 or chapter 2 of the Internal Revenue Code of 1939, a recovery on account of such losses is considered as made on account of such losses in the order of the taxable years for which they were allowed beginning with the latest. See § 1.1337–1 for the determination of the amount of such deductions. Recoveries in excess of such amount are treated as ordinary income until such excess equals the amount of the taxpayer's allowable deductions in prior taxable years on account of war losses which did result in a reduction of any such tax under chapter 1 or chapter 2 of the Internal Revenue Code of 1939. Any further recoveries in excess of all the taxpayer's allowable deductions in prior taxable years for war losses are treated as gain on an involuntary conversion of property as a result of its destruction of seizure, and such gain is recognized or not recognized under the provisions of section 1033. See section 1033 and the regulations thereunder. Such gain, if recognized, is included in gross income as ordinary income unless section 1231(a) applies to cause such gain to be treated as gain from the sale or exchange of a capital asset held for more than six months. See section 1231(a) and the regulations thereunder.

(2) The determination as to whether and to what extent any recoveries are to be included in gross income is made upon the basis of the amount of all the recoveries for each day upon which there are any such recoveries, as follows:

(i) The amount of the recoveries for any day is not included in gross income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of the allowable deductions in prior taxable years on account of war losses which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code of 1939, as determined under § 1.1337–1, exceeds the amount of all previous recoveries in the same and prior taxable years.

(ii) The amount of the recoveries for any day which is not excluded from gross income under subdivision (i) of this subparagraph is included in gross income as ordinary income, and is

not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of all the allowable deductions in prior taxable years on account of war losses (both those which resulted in a reduction of a tax of the taxpayer and those which did not) exceeds the sum of the amount of all previous recoveries in the same and prior taxable years and of that portion, if any, of the amount of the recoveries for such day which is not included in gross income under subdivision (i) of this subparagraph.

(iii) The amount of the recoveries for any day which is not excluded from gross income under subdivision (i) of this subparagraph and is not included in gross income as ordinary income under subdivision (ii) of this subparagraph is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions then apply to this gain:

(*a*) Such gain is recognized or not recognized under the provisions of section 1033, relating to gain on the involuntary conversion of property. For the purpose of applying section 1033, such gain for any day is deemed to be expended in the manner provided in section 1033 to the extent the recovery for such day is so expended.

(*b*) If such gain is recognized, it is included in gross income as ordinary income or, if the provisions of section 1231 (a) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. For the purpose of applying section 1231 (a), such recognized gain for any day is deemed to be derived from property described in that section to the extent of the recovery for such day with respect to such property, except such portion of such recovery as is attributable to the nonrecognized gain for such day.

(*c*) Section 1336 provides that in determining the unadjusted basis of recovered property, the total gain and the recognized gain with respect to such property must be determined. For such purpose, the recognized gain deemed to be derived from properties described in section 1231 (a) may be allocated among such properties in the proportion of the recoveries with respect to such properties, reduced for each property by the portion of the recovery attributable to the nonrecognized gain for such day, and the recoveries with respect to properties not described in section 1231 (a) may be similarly allocated. The total gain derived from any recovered property is the sum of the nonrecognized gain attributable to the recovery of such property and of the recognized gain allocable to such property.

(3) The foregoing provisions may be illustrated by the following examples:

Example (1). The taxpayer sustained war losses of $3,000 on account of properties A, B, C, and D. Of this amount, $1,000 did not result in a reduction of any income tax of the taxpayer, as determined under the provisions of § 1.1337–1. In a subsequent taxable year, he received an award of $800 from the Gov-

ernment on account of property A. This is not included in income since it is less than the amount by which his allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) exceed $0, the sum of all his previous recoveries. On a later date the taxpayer recovers property B, which is worth $1,500 on the date of recovery. This recovery is not included in gross income to the extent of $200, the amount by which the aggregate of the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) exceeds the sum of all previous recoveries ($800). The remaining $1,300 of the recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, since it is less than the amount by which the aggregate of all the allowable deductions in prior taxable years on account of war losses ($3,000) exceeds $1,000, the sum of the $800 of previous recoveries and of the $200 portion of the recovery with respect to B which is not included in gross income. On a still later date the taxpayer sells for $2,500 his rights to recover C. Since the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) do not exceed the previous recoveries by the taxpayer ($800 and $1,500, or $2,300), none of the recovery on account of C is excluded from gross income. This recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, to the extent of $700, the amount by which the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) exceeds $2,300, the sum of the $2,300 of previous recoveries and of the $0 portion of the recovery on account of C which is not included in gross income. The remaining $1,800 of the recovery is considered gain on an involuntary conversion of property on account of its destruction or seizure, and is not recognized if forthwith expended in the manner provided in section 1033. Thus, it is not recognized if it is forthwith expended for the acquisition of property relating in service or use to C. On a later date the taxpayer recovers D, which has a fair market value of $400 at the time of the recovery. Since the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) does not exceed the previous recoveries by the taxpayer ($800+$1,500+$2,500, or $4,800), all of the recovery with respect to D is considered gain on an involuntary conversion of property as a result of its destruction or seizure. Under the provisions of section 1033, this gain is not recognized if D is used for the same purposes for which it was used before it was deemed destroyed or seized under section 127 (a) of the Internal Revenue Code of 1939.

Example (2). The taxpayer on one day recovers $3,000 for property A and $7,000 for property B, both of which were treated as war loss property for a prior taxable year, and $8,000 of such $10,000 recoveries is considered gain on the involuntary conversion of property as a result of its destruction or seizure. The taxpayer forthwith expends $5,000 in the acquisition of property similar in use to B. Therefore, $5,000 of the $8,000 gain is not

recognized under section 1033, leaving $3,000 of recognized gain. Property B is within the provisions of section 1231 (a), relating to gains and losses on the involuntary conversion of certain described property, but property A is not. Therefore, the provisions of section 1231 (a) apply to $2,000 of the $3,000 gain, that is, the amount of the recovery with respect to B which is not attributable to the nonrecognized gain for such day ($7,000 minus $5,000). If the taxpayer forthwith expended $8,000 or more for the acquisition of property similar in use to B, none of the gain would be recognized. If the taxpayer forthwith expended the $5,000 to acquire property related in use to A, the $3,000 recognized gain would be considered derived from B to the extent of the recovery with respect to B ($7,000), not reduced by any nonrecognized gain since none of such recovery is attributable to such nonrecognized gain, and therefore all of the $3,000 recognized gain would be subject to the provisions of section 1231(a).

(4) An allowable deduction with respect to a war loss is any deduction to which the taxpayer is entitled on account of any war loss property, regardless of whether or not such deduction was claimed by the taxpayer or otherwise allowed in computing his tax. If a deduction was claimed by a taxpayer in computing his tax for any taxable year and if such deduction was disallowed, such deduction will not be considered an allowable deduction for such taxable year since the previous determination will not be reconsidered.

§ 1.1333 Statutory Provisions; Tax Adjustment Measured by Prior Benefits.

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 purposes 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.

§ 1.1333–1 TAX ADJUSTMENT MEASURED BY PRIOR BENEFITS—(a) *Amount of recovery.*—The amount of recovery for purposes of this section shall be determined in accordance with the provisions of section 1332(a). See § 1.1332–1(a). If, pursuant to the taxpayer's election under section 1335, the provisions of section 1333 are applicable to any taxable year in which he recovers the same war loss property, the fair market value of such property shall, at the option of the taxpayer, be considered an amount equal to the adjusted basis (for determining loss) of such property in the hands of the taxpayer on the date such property was considered as destroyed or seized. This option is exercisable by the taxpayer with respect to each separate war loss property. Also, if the provisions of section 1333 are applicable pursuant to the taxpayer's election, the amount of the recovery of any money or property in respect of war loss property shall be reduced for the purpose of section 1333(2) and (3) by the amount of the obligations or liabilities with respect to such property, if the taxpayer for any previous taxable year chose under section 127(b)(2) of the Internal Revenue Code of 1939 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. See § 29.127(b)-1 of Regulations 111 (26 CFR (1939) 29.127(b)-1).

(b) ELECTIVE METHOD; TAX ADJUSTMENT MEASURED BY PRIOR BENEFITS.—(1) If the taxpayer elects pursuant to section 1335 and in accordance with the provisions of § 1.1335-1 to have the provisions of section 1333 apply to any taxable year in which he recovers any money or property in respect of war loss property, the amount of the recovery in respect of such property for any taxable year shall not be included in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of the destruction or seizure of such property, whether or not such allowable deductions resulted in a reduction of any tax under chapter 1 or chapter 2 of the Internal Revenue Code of 1939. However, for the purposes of section 6012(a)(1), relating to the requirement of individual returns, section 6012(a)(2), relating to the requirement of corporation returns, and section 1312, relating to the mitigation of the effect of the statute of limitations, the entire amount of the recovery shall be deemed to be an item includible in gross income for the taxable year in which the recovery is made. In lieu of including such amount in gross income, there shall be added to, and assessed and collected as a part of, the tax imposed under subtitle A for the taxable year of the recovery an adjustment on account of any tax benefits in all prior taxable years resulting directly or indirectly from the fact that the loss from the destruction or seizure of such property was an allowable deduction. The amount of such adjustment shall be 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 such allowable deductions with respect to the destruction or seizure of such property by an amount equal to that portion of the amount of the recovery which is not included in gross income for the taxable year of the recovery. The portion of the amount of the recovery which is in excess of such allowable deductions is included in gross income for the taxable year of the recovery as gain on the involuntary conversion of property as a result of its destruction or seizure and is recognized or not recognized as provided in section 1033. See section 1033 and the regulations thereunder. Such gain, if recognized, is included in gross income as ordinary income unless section 1231(a) applies to cause such gain to be treated as gain on the sale or exchange of capital assets held for more than six months. See section 1231(a) and the regulations thereunder.

(2) The determination as to whether and to what extent the amount of the recovery is to be excluded from gross income is to be made upon the basis of the total amount of the recoveries in each taxable year in respect of the same war loss property, as follows:

(i) The amount of the recovery in any taxable year is excluded from the gross income of such year and is not considered gain on an involuntary conversion to the extent that such amount does not exceed the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of such property (whether or not such deductions resulted in a reduction of a tax of the taxpayer) reduced by the aggregate amount of any recoveries in intervening taxable years in respect of the same property.

(ii) The amount of the recovery in any taxable year which is not excluded from gross income under subdivision (i) of this subparagraph is included in gross income and is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions apply to this gain:

(*a*) Such gain is recognized or not recognized under the provisions of section 1033, relating to gain on the involuntary conversion of property. For the purpose of applying section 1033, such gain for any taxable year is deemed to be expended in the manner provided in section 1033 to the extent the recovery in such taxable year is so expended.

(*b*) If such gain is recognized it is included in gross income as ordinary income or, if the provisions of section 1231 (a) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. In the case of the recovery of the same war loss property, any gain will not be deemed to be recognized under the provisions of section 1231(a) if such property is used for the same purpose for which it was used before it was deemed destroyed or seized under section 127(a) of the Internal Revenue Code of 1939.

(3) The determination of 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 the deductions allowable in any prior taxable year with respect to the destruction or seizure of the property in respect of which the taxpayer has made a recovery by an amount equal to the part of such recovery not included in gross income for the taxable year of such recovery shall be made as provided in this subparagraph. Such total increase shall include the increases described in subdivisions (i), (ii), (iii), and (iv) of this subparagraph, and shall be added to, and assessed and collected as a part of, the tax under subtitle A for the taxable year of the recovery. Proper adjustment of such increases shall be made on account of the application of the provisions of this subparagraph to intervening taxable years. Proper adjustment shall also be made in the determination of such increases in the case of a taxpayer who has made a valid election under section 1020, relating to the adjustment of basis of property for depreciation, obsolescence, amortization, and depletion. The term "tax previously determined" as used in this subparagraph shall have the same meaning as used in section 1314(a) and shall include any tax under chapter 1 or chapter 2 of the Internal Revenue Code of 1939. In computing the amount of the increase in the tax previously determined under chapter 1 or chapter 2 of the Internal Revenue Code of 1939 for any taxable year, the principles of section 1314(a) shall be applicable. See section 1314(a) and the regulations thereunder. However, the computation of the excess profits credit under chapter 2E of the Internal Revenue Code of 1939 for any taxable year shall not be affected by the adjustment provided in this subparagraph. All credits allowable against the tax for any year shall be taken into account in computing the increase in the tax previously determined. The increases referred to above include the following:

(i) The increase, if any, in the tax previously determined for each prior taxable year in which a deduction was allowable on

account of the destruction or seiure of the property in respect of which there is a recovery in the taxable year. After the tax previously determined has been ascertained, such tax shall be recomputed by disregarding such allowable deduction (to the extent that it does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and any other deductions allowable on account of other war losses or any other losses, expenditures or accruals in such prior taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or section 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or section 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year.

(ii) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of the recovery) in which a net operating loss deduction was allowable, if all or a part of such deduction was attributable to the carryover or carryback to such taxable year of a net operating loss from another taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such net operating loss deduction. In the determination of such net operating loss deduction the net operating loss shall be recomputed by disregarding the deduction allowable on account of the war loss in respect of which there is a recovery in the taxable year to which such increase is to be added (to the extent that such deduction does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or section 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or section 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year.

(iii) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of recovery) in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment for such taxable year, if all or a part of such adjustment was attributable to the carryover or carryback to such taxable year of an unused excess profits credit from another taxable year in which a deduction was allowable on account of the destruction or seizure of the property in

respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such unused excess profits credit carryover or carryback. In the recomputation such carryover or carryback shall be redetermined by disregarding such allowable war loss deduction (to the extent such deduction does not exceed the sum of the amount of the recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expeditures. or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or section 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or section 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year. In case there is an increase in the excess profits tax under chapter 2E of the Internal Revenue Code of 1939 for the taxable year in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment, and a decrease in the income tax under chapter 1 of the Internal Revenue Code of 1939 for such taxable year, the increase in the tax previously determined shall be considered to be an amount equal to the excess of the increase in the excess profits tax over the decrease in the income tax.

(iv) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of the recovery) in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment for such taxable year, if all or a part of such adjustment was attributable to the carryover or carryback to such taxable year of an unused excess profits credit from another taxable year in which there was allowable a net operating loss deduction attributable to the carryover or carryback to such other taxable year of a net operating loss, and such net operating loss resulted in whole or in part from the deduction allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such net operating loss deduction and such unused excess profits credit carryover or carryback. In the redetermination of such net operating loss deduction the net operating loss carryover or carryback shall be recomputed by disregarding such allowable war loss deduction (to the extent that such deduction does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding

any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127(c)(3) or section 22(b)(12) of the Internal Revenue Code of 1939, or section 1333 or section 111 of the Internal Revenue Code of 1954, or otherwise. The unused excess profits credit carryover or carryback shall then be recomputed to conform to the redetermination of the net operating loss deduction for the taxable year from which the unused credit is carried over or carried back. The difference between the tax previously determined and the tax as recomputed shall be the amount of the increase which shall be added to the tax for the taxable year of the recovery. In case there is an increase in the excess profits tax under chapter 2E of the Internal Revenue Code of 1939 for the taxable year in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment, and a decrease in the income tax under chapter 1 of the Internal Revenue Code of 1939 for such taxable year, the increase which shall be added to the tax for the taxable year of the recovery shall be considered to be an amount equal to the excess of the increase in the excess profits tax over the decrease in the income tax.

§ 1.1334 STATUTORY PROVISIONS; RESTORATION OF VALUE OF INVESTMENTS REFERABLE TO DESTROYED OF SEIZED PROPERTY.

SEC. 1334. RESTORATION OF VALUE OF INVESTMENTS REFERABLE TO DESTROYED OR SEIZED PROPERTY.

For the 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.

§ 1.1334–1 RESTORATION OF VALUE OF INVESTMENTS.—If any interest of the taxpayer in or with respect to property was determined to be worthless and was treated as a war loss under section 127(a)(3) of the Internal Revenue Code of 1939 (see § 29.127(a)–4 of Regulations 111 (26 CFR, 1949 ed., Supps.)), or if the taxpayer retained an interest in a corporation with respect to which he sustained a war loss under section 127(e) of the Internal Revenue Code of 1939, and if the interest in the hands of the taxpayer is restored in value, in whole or in part, by reason of a recovery with respect to the underlying assets treated as war loss property, then such restoration in value is a recovery by the taxpayer for the purposes of section 1331. In the application of section 1333, such restoration shall be treated as a recovery of the same interest considered as destroyed or seized. War loss property is considered as not being in existence from the date of the loss to the date of its recovery.

§ 1.1335 STATUTORY PROVISIONS; ELECTION BY TAXPAYER FOR APPLICATION OF SECTION 1333.

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

(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.

§ 1.1335–1 ELECTIVE METHOD; TIME AND MANNER OF MAKING ELECTION AND EFFECT THEREOF—(a) *In General.*—If the taxpayer elects to have the provisions of section 1333 applicable to any taxable year in which any money or property is recovered in respect of war loss property, section 1333 will be applicable by virtue of that election to all taxable years of the taxpayer beginning after December 31, 1941. Thus, the taxpayer need not make an election with respect to each separate taxable year in which he had a recovery. An election for any taxable year in which the taxpayer had a recovery in respect of a prior war loss is sufficient to make the provisions of section 1333 applicable not only to war loss recoveries received by the taxpayer in any past taxable year beginning after December 31, 1941, but to any recoveries which may be received by the taxpayer in any future taxable year. Such election once made shall be irrevocable. The election to have the provisions of section 1333 applicable to any taxable year cannot be made unless the taxpayer recovers money or

property (in respect of a prior war loss) during the taxable year for which such election is made.

(b) *Manner of election.*—In all cases the election to have the provisions of section 1333 apply must be made by the taxpayer not later than six months from the last day prescribed by law for the filing of his income tax return for the taxable year in which the recovery of war loss property occurs. The election shall be evidenced by a written statement that the taxpayer elects to have the provisions of section 1333 apply to any taxable year in which any money or property is recovered in respect of war loss property. The statement may be made in (or attached to)—

(1) The return or amended return filed for such taxable year;

(2) A claim for refund or credit filed for such taxable year for an overpayment resulting from application of such provisions.

(3) A timely petition or amended petition to The Tax Court of the United States for a redetermination of any deficiency for such taxable year;

(4) A letter addressed to the district director for the district in which the return for such taxable year was required to be filed.

If the written statement of election is made in a letter, it shall be signed by the taxpayer making the election if an individual or, if the taxpayer is not an individual, the letter must be executed in the same manner as required in the case of the income tax return of such taxpayer. The date of the making of the election shall be the date the return, amended return, claim for refund or credit, or letter is filed in the office of the district director, or the date the petition or amended petition is filed with The Tax Court of the United States. In case the election is made in a return filed before the last day prescribed by law for the filing thereof (including any extension of time for such filing), such election shall not be considered made until such last day. See section 7502 and the regulations thereunder with respect to the timeliness of filing an election where filing is done by mail and section 7503 and the regulations thereunder with respect to the timeliness of filing where the last day for filing falls on a Saturday, Sunday, or legal holiday.

(c) *Effect of election.*—(1) If the provisions of section 1333 are applicable to any taxable year pursuant to an election made by the taxpayer in accordance with the provisions of paragraph (a) of this section, 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 with respect to (i) the amount to be added to the tax for such taxable year under the provisions of section 1333 and (ii) 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 the provisions of section 1336(b), shall not expire prior to the expiration of two years following the date of the making of such election. Such amount or such deficiency may be assessed at any time prior to the expiration of such period, notwithstanding any law or rule of law which would otherwise prevent such assessment and collection.

(2) If the provisions of section 1333 are applicable to any taxable year pursuant to an election made by the taxpayer in accordance with

the provisions of paragraph (a) of this section, and refund or credit of any overpayment resulting from the application of such provisions 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, provided claim therefor is filed within one year from such date. Thus, the amount of such overpayment which may be refunded or credited is not subject to the limitations contained in section 6511 or 6512(b).

(3) In the case of any taxable year ending before the date of the making by the taxpayer of an election under section 1335, no interest shall be paid on any overpayment specified in subparagraph (2) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer, and no interest shall be assessed or collected with respect to any amount or any deficiency specified in subparagraph (1) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer.

§ 1.1336 STATUTORY PROVISIONS; BASIS OF RECOVERED PROPERTY.

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 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.

§ 1.1336–1 BASIS OF RECOVERED PROPERTY—(a) *General rule.*—(1) Under section 1336(a), the unadjusted basis of any war loss property which is recovered and the unadjusted basis of any property which is recovered in lieu of or on account of any such war loss property is considered the fair market value of such recovered property upon the date of its recovery with the following adjustments:

(i) If the sum of the recoveries for the day such property is recovered and of all previous recoveries exceeds the aggregate of

the allowable deductions for prior taxable years on account of war losses, so that a portion of the recoveries for such day is treated as gain on the involuntary conversion of property, such fair market value of the property is reduced by the total gain, if any, for such day derived from such recovered property as determined under § 1.1332–1(b).

(ii) Such fair market value, as reduced under subdivision (i) of this subparagraph, is increased by the portion, if any, of the recognized gain resulting from the recoveries for such day which is allocable to such recovered property, as determined under § 1.1332–1(b). In effect, the unadjusted basis of such property is its fair market value upon the date of its recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of § 1.1332–1(b).

(2) If the respective bases of several properties of a taxpayer determined under section 1336(a) are greatly disproportionate to their adjusted bases immediately before their treatment as war loss properties, the taxpayer may apply to the Commissioner for the allocation of the aggregate of the bases of such properties among them in the proportion of their adjusted bases immediately before the destruction or seizure of such properties determined under section 127(a) of the Internal Revenue Code of 1939. The amount so allocated to any such property, in an application approved by the Commissioner, shall be the unadjusted basis of such property in lieu of the amount determined under subparagraph (1) of this paragraph.

(3) The application to the Commissioner shall set forth a list of all the properties of the taxpayer having an unadjusted basis determined under this section, a description of each such property together with a statement as to the amount of its adjusted basis immediately before the destruction or seizure of such property determined under section 127(a) of the Internal Revenue Code of 1939, and a statement as to whether there has been any substantial change in the use or nature of the property chosen for the allocation from its nature or use immediately before the time it was treated as destroyed or seized. Such application will be allowed unless there has been such a substantial change in the nature or use of such property that the allocation of the bases would produce an arbitrary result, or unless the taxpayer has obtained such tax benefits by reason of the basis determined under subparagraph (1) of this paragraph, that it would be inequitable to change his basis. Thus, the allocation will not be allowed if it would give the taxpayer an unadjusted basis with respect to any property which is less than the amount of the adjustments in reduction of the basis of such property which are allowable after its recovery. For example, when property A is recovered it has an unadjusted basis of $100. After $70 depreciation has been allowed on A, an allocation is sought which would give A an unadjusted basis of $60. Since this is less than the depreciation which is an adjustment against such basis, the allocation will not be permitted.

(4) The amount of any adjustments to the unadjusted basis determined under subparagraph (1) of this paragraph shall, upon the allocation of the bases, be taken as an adjustment to the allocated unadjusted basis. Thus, if $30 depreciation was allowed upon a $100 basis determined under subparagraph (1) of this paragraph and if

the unadjusted basis upon allocation is $75, such $30 depreciation is allowed against such allocated unadjusted basis, so that the adjusted basis of the property is then $45.

(5) The taxpayer may choose any group of recovered properties for allocation, except that if any such recovered properties form one economic unit, such properties may not be separated but all or none must be included in the group. For example, a building may not be separated from the land on which it stands if both are recovered property, nor may one block of stock in a corporation be separated from other stock in such corporation or from bonds in such corporation which are also treated as a recovery. If the taxpayer has once been permitted to allocate the bases of any group of properties, he may obtain another allocation with respect to such properties only if all the properties in the original group are included together with other recovered properties not included in the original group. For example, if the bases of properties A and B are allocated, a second allocation will be made for properties A, B, and C, but not for A and C or B and C.

(b) *Property recovered in taxable year to which section 1333 is applicable.*—If, pursuant to an election made by the taxpayer under section 1335 and § 1.1335–1(a), the provisions of section 1333 are applicable to any taxable year in which the taxpayer recovered property in respect of a war loss under section 127(a) of the Internal Revenue Code of 1939, the unadjusted basis of such property shall be the fair market value of such property determined as of the date of the recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of § 1.1333–1(b). However, if the property recovered is the same war loss property, and if the taxpayer under section 1333(1) includes such property in the amount of the recovery at its adjusted basis (for determining loss) in his hands on the date such property was considered under section 127(a) of the Internal Revenue Code of 1939 as destroyed or seized, the unadjusted basis of such property shall be such adjusted basis, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of § 1.1333–1(b). The fair market value of any property recovered, or the adjusted basis (for determining loss) of such property if the same property treated as war loss property is recovered, shall not be reduced in determining the unadjusted basis of such property by the amount of the obligations or liabilities with respect to such property in respect of which the recovery was received, if the taxpayer for any previous taxable year chose under section 127(b)(2) of the Internal Revenue Code of 1939 to treat such obligations or liabilities as discharged or satisfied out of such property but such obligations or liabilities were not so discharged or satisfied prior to the date of the recovery.

§ 1.1337 Statutory Provisions; Applicable Rules.

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.

§ 1.1337–1 *Determination of tax benefits from allowable deductions.*—(a) That part of the aggregate of the deductions allowed a taxpayer for any taxable year on account of war losses under section 127(a) of the Internal Revenue Code of 1939 which, if disallowed, would not result in an increase in the normal tax, surtax (including the tax imposed by section 102 of the Internal Revenue Code of 1939), or victory tax of taxpayer, or of any tax imposed in lieu of such taxes or of any tax imposed by chapter 2 of the Internal Revenue Code of 1939, for the taxable year in which such deductions are allowed or in any other taxable year, such as a taxable year in which the taxpayer's income tax is computed by reference to a carryover or carryback of net operating losses from the taxable year in which such deductions are allowed, is considered, for the purposes of section 127(a) of the Internal Revenue Code of 1939 an allowable deduction for the taxable year which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code of 1939. In the case of recoveries of war losses and other items to which the recovery exclusion provisions of section 111 apply, such as bad debts, the determination of the tax benefit should be made in accordance with section 111 (b) and the regulations thereunder. The deductions allowed a taxpayer for any taxable year on account of war losses are all the deductions on account of war losses which were claimed by the taxpayer in a return, in a claim for credit or refund of an overpayment, or in a petition to The Tax Court of the United States with respect to such taxable year and which were not disallowed, and all deductions on account of war losses which, although not so claimed by the taxpayer, were nevertheless allowed (for example, by the Commissioner, a court, or The Tax Court) in computing a tax of the taxpayer.

(b) Any deduction allowable for a taxable year on account of a war loss under section 127 (a) of the Internal Revenue Code of 1939 which was not claimed by the taxpayer for such year in a return, a claim for credit or refund of an overpayment, or a petition to The Tax Court of the United States and was not allowed as a deduction (for example, by the Commissioner, a court, or the Tax Court) in computing his tax for such year or for any other year is considered a deduction which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code of 1939, since it is an allowable deduction which was not allowed in computing any tax of the taxpayer. If the taxpayer claimed for any taxable year a deduction on account of a war loss, and if such deduction was disallowed, the taxpayer may not subsequently contend for the purposes of section 1331 that such deduction was an allowable deduction for such taxable year.

(c) If the taxpayer elected under section 127 (b) of the Internal Revenue Code of 1939 to decrease the amount of a war loss by treating the obligations and liabilities described in that section as discharged or satisfied out of the property destroyed or seized, and if the taxpayer establishes that any of the obligations and liabilities were not

so discharged or satisfied, then the amount by which such continuing obligations and liabilities decreased the war loss shall be considered an allowable deduction for the taxable year in which the war loss was sustained which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code of 1939.

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved: March 8, 1956.
DAN THROOP SMITH,
Special Assistant to the Secretary
in Charge of Tax Policy.

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CHAPTER 2.—TAX ON SELF-EMPLOYMENT INCOME

SECTION 1402.—DEFINITIONS

(Also Section 3121.) Rev. Rul. 56-66

An individual rents and operates a shoe shine stand as a separate trade or business in a barber shop where he also performs services as a porter. *Held*, the income derived from the operation of the shoe shine stand is includible in computing net earnings from self-employment for purposes of the Self-Employment Contributions Act.

In S. S. T. 147, C. B. 1937-1, 379, it is held that an individual who serves as a porter in a barber shop for the privilege of operating a shoe shine stand therein is an employee of the barber shop with respect to the services which he performs as such porter and that the fair rental value of the shoe shine stand constitutes the amount of his remuneration or "wages" for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954).

A question has now been presented to the Internal Revenue Service relative to the treatment, for purposes of the tax imposed under the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954), of the income derived by the individual from the shoe shine stand rented by him and operated as a separate trade or business.

Section 1402(a) of the Self-Employment Contributions Act of 1954 defines the term "net earnings from self-employment" as "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 * * *."

Accordingly, it is held that income derived from the operation of a shoe shine stand by an individual who rents and operates such stand as a separate trade or business in a barber shop, where he also performs services as a porter, is includible in computing net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954. In computing the amount of self-employment income subject to tax, the fair rental value of the shoe shine stand should be treated as "wages paid" to the operator of the stand in applying section 1402 (b) of the last-mentioned Act since such fair rental value con-

stitutes "wages" for purposes of the Federal Insurance Contributions Act. See Rev. Rul. 54–223, C. B. 1954–1, 174. Thus, the amount of the fair rental value of the shoe shine stand would constitute (1) wages paid to the individual involved to be reported both for Federal employment and income tax purposes and (2) a deduction attributable to the operation of the shoe shine stand as a trade or business.

The conclusions stated herein may be illustrated as follows:

The fair rental value of a stand is $20 per month, or $240 for the year; shine fees and tips received during the year total $1800; and the cost of materials (rags, oils, polish, etc.) used during the year is $100. Applying the principle of S. S. T. 147 *supra*, to this example, $240 is the amount to be included in wages under the Federal Insurance Contributions Act; the amount of $240 also represents rental expenses and is a deductible expense to the operator of the stand; adding the $240 to the $100, the cost of materials, results in a total deduction of $340; and, deducting the $340 from the $1800 of income leaves a remainder of $1460, representing the amount of self-employment earnings from the stand to be reported by the operator.

(Also Section 107.) Rev. Rul. 56–85

A duly ordained minister of a church, who elects under section 1402(e), as added to the Internal Revenue Code of 1954, to have the insurance system established by Title II of the Social Security Act extended to services which he performs in the exercise of his ministry, should exclude from the net earnings from self-employment for a taxable year ending after 1954 the value of a home furnished to him as a part of his compensation or the rental allowance paid to him as a part of his compensation to the extent used by him to rent or provide a home.

Advice has been requested as to the amount to be included in net earnings from self-employment by a duly ordained minister of a church who has elected social security coverage and who, in 1955, in addition to cash salary will receive either (a) free occupancy of a house, or (b) a cash rental allowance in lieu of a house.

Section 1402(e), as added to the Internal Revenue Code of 1954 by Public Law 761, 83d Cong., 68 Stat. 1087, 26 U. S. C. 1402, 1952 Edition, Supplement II, C. B. 1954–2, 603, provides, among other things, that a duly ordained, commissioned, or licensed minister of a church may, under the circumstances stated therein, certify that he elects to have the insurance system established by Title II of the Social Security Act extended to services performed in the exercise of his ministry.

Section 107 of the Code provides that gross income does not include the rental value of a home furnished to a minister of the gospel as part of his compensation, or the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home.

Accordingly, it is held that a duly ordained minister of a church, who elects under section 1402(e) of the Code to have the insurance system established by Title II of the Social Security Act extended to services which he performs in the exercise of his ministry, should exclude from the net earnings from self-employment the value of a home furnished to him as a part of his compensation as a minister, or the rental allowance paid to him as a part of such compensation to the extent used by him to rent or provide a home.

(Also Section 3121.) Rev. Rul. 56–172

An individual operates a school bus pursuant to an agreement with a county board of education whereby he is required to furnish and maintain his own bus, perform the services personally except in case of illness, attend safety meetings, file monthly reports, and follow certain rules pertaining to time schedules, routes, observance of safety rules, treatment of pupils, personal appearance and conduct. He is remunerated on the basis of x dollars per seat plus y cents per mile traveled. *Held*, the operator is an employee of the county for Federal employment tax purposes. Accordingly, the remuneration for such services does not constitute "net earnings from self-employment" as income from a "trade or business" under the Self-Employment Contributions Act of 1954.

The Internal Revenue Service has been requested to determine whether remuneration received by a bus operator for providing bus transportation for school children under an agreement with a county board of education constitutes "net earnings from self-employment" for purposes of the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954).

Section 1402 of the Act provides in part:

(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 [Subtitle A] which are attributable to such trade or business, * * *

* * * * * * *

(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, * * *, except that such term shall not include—

* * * * * * *

"(2) the performance of service by an individual as an employee * * *.

Whether a certain activity constitutes a "trade or business" is dependent upon all the facts and circumstances in the particular case. As a general rule, when a person is regularly engaged in an occupation or profession for profit and, as to such occupation or profession, is not regarded as an employee for purposes of the taxes imposed by the Federal Insurance Contributions Act, or otherwise excluded from the self-employment provisions, he is engaged in a "trade or business."

In view of the exclusion set forth by section 1402(c)(2) of the Self-Employment Contributions Act of 1954 regarding services performed as an employee, consideration must be given to the circumstances under which the services of the bus operator are performed for the county in order to determine whether or not such services are performed in an employer-employee relationship.

Pursuant to an oral agreement between the bus operator and the board, the operator is required to use his own bus which he maintains and operates at his own expense; perform the services personally except in the case of illness, when he may assign a substitute approved by the board; and to follow certain rules with respect to time schedules, routes, observance of safety rules, treatment of pupils, personal appearance and conduct. Occasionally, he receives instructions from school officials regarding changes in bus routes and his working hours. He is further required to attend safety meetings and to submit

monthly reports of his services, which must be approved by the board, as a condition precedent to payment of his remuneration. He may be discharged for unsatisfactory services and he may terminate his services at any time. He is remunerated on the basis of x dollars per seat plus y cents per mile traveled.

Section 3121(d) of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954) provides, in part, that the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The guides for determining, under the common law rules, whether an employer-employee relationship exists are found in section 408.204(c) of Regulations 128, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

In Em. T. 442, C. B. 1943, 1069, it was held that A, who operated school buses under contract with the board of education of a school district in the state of R, was an independent contractor and was the employer, for social security and employment tax purposes, of the individuals assisting him in the performance of his contract with the board. In that case, A was not required to perform the services personally; neither A nor his assistants were required to file reports with the board; and the board had nothing to do with the hiring of A's assistants. The contract, when reviewed in the light of the overall factual situation, was held to be a contract for a hauling service rather than a contract for the use of equipment and a driver in the business of another under which the driver and equipment are assimilated in the business of the employer and become subject to his direction and control.

In the instant case, it is concluded that the bus operator has entered into a contract of employment with the county board of education to perform personal services under the direction and control of the board. Accordingly, it is held that he is an employee of the board for Federal employment tax purposes. The remuneration for his services, therefore, does not constitute "net earnings from self-employment" from a "trade or business" under the Self-Employment Contributions Act of 1954. His services for the county board of education, which is an instrumentality of the county, are excepted from "employment" under the provisions of section 3121(b)(7) of the Federal Insurance Contributions Act, and his remuneration for such services is not subject to the taxes under such Act. However, his remuneration constitutes "wages" subject to the withholding of income tax under section 3402 of the Internal Revenue Code of 1954.

Service performed for municipalities. See Rev. Rul. 56–2, page 496.

Income from the operation of a "cash and carry" laundry and dry cleaning agency. See Rev. Rul. 56–15, page 451.

Self-employment income of person under disability. See Rev. Rul. 56–22, page 558.

Fees received by an individual rendering child care services in her own home. See Rev. Rul. 56–70, page 460.

An individual performing geological engineering research for clients. See Rev. Rul. 56–132, page 475.

Services performed by a minister in an executive capacity. See Rev. Rul. 56–187, page 483.

CHAPTER 6.—CONSOLIDATED RETURNS

SUBCHAPTER A.—RETURNS AND PAYMENT OF TAX

SECTION 1501.—PRIVILEGE TO FILE CONSOLIDATED RETURNS

26 CFR 1.1501–1: Privilege to file consolidated returns.
(Also Section 1504.)
(Also Part II, Section 141;
Regulations 118, Section 39.141–1.)

Rev. Rul. 56–34

A chain of includible subsidiary corporations whose stocks were less than 95 percent owned by the parent corporation during the taxable year 1953, and were therefore not members of an affiliated group for tax purposes for that year, but whose stocks were more than 80 percent so owned at the beginning of and for four months of the calendar year 1954, are considered as being members of an affiliated group for four months of the calendar year 1954 under the provisions of section 1504(a) of the Internal Revenue Code of 1954. If a consolidated income tax return is filed for 1954, the income of each includible corporation, which became a member of the affiliated group during 1954, is required to be included in the consolidated return for such part of the taxable year as it was a member of the affiliated group.

Advice has been requested whether a chain of includible subsidiary corporations, which were not members of an affiliated group for tax purposes for calendar years beginning prior to January 1, 1954, are considered to have been members of an affiliated group for a period of four months of the calendar year 1954, their common taxable year, by reason of the application of the 80 percent provisions of section 1504(a) of the Internal Revenue Code of 1954; and, if such corporations were members of an affiliated group and a consolidated income tax return is filed by the group for the taxable year 1954, whether the income of each such corporation is required to be included in the consolidated return for such part of the taxable year as it was a member of the affiliated group.

X company is the common parent of an affiliated group of wholly owned corporations which filed consolidated returns for the calendar year 1953 and for all years since 1931 for which such returns were per-

mitted. During most of such period and until April 30, 1954, *X* company also owned more than 80 percent but less than 95 percent of the stock of 22 other subsidiaries. The 22 subsidiaries in this latter group have always filed separate income tax returns since they did not come within the stock ownership requirements of an affiliated group as provided in section 141(d) of the Internal Revenue Code of 1939. Section 141(d) defines the term "affiliated group" as meaning—

> * * * 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 95 per centum of the voting power of all classes of stock and at least 95 per centum 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 95 per centum of the voting power of all classes of stock and at least 95 per centum 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.

Section 1501 of the Internal Revenue Code of 1954 provides that in the case of a corporation, which is a member of an affiliated group for a fractional part of the year, the consolidated return, if elected to be filed by the affiliated group, shall include the income of such corporation for such part of the year as it is a member of the affiliated group. Section 1504(a) of the 1954 Code defines an "affiliated group" in the same way as section 141(d) of the 1939 Code, except that the required percentage of ownership has been reduced from 95 percent to 80 percent.

Accordingly, it is held that a chain of includible subsidiary corporations whose stocks were less than 95 percent owned by the parent corporation during the calendar year 1953, and were therefore not members of an affiliated group for tax purposes for that year, but whose stocks were more than 80 percent so owned at the beginning of and for four months of the calendar year 1954, are considered as being members of an affiliated group for four months of the calendar year 1954 under the provisions of section 1504(a) of the 1954 Code. If a consolidated income tax return is filed for 1954, the income of each of the includible corporations, which became a member of the affiliated group during 1954, is required to be included in the consolidated return for such part of the calendar year as it was a member of the affiliated group.

Rev. Rul. 56–67

> Where an affiliated group of corporations has an election to make either consolidated or separate returns and has properly filed a consolidated Federal income tax return for a taxable year, the members of the affiliated group may file their returns on a separate basis on or before the due date of such returns, including any extension of time granted by the Commissioner, provided the payments heretofore made and to be made are adjusted in a manner satisfactory to the Commissioner. Similarly, a consolidated return may properly be filed on or before the due date notwithstanding the earlier filing of separate returns.

A question has been presented as to whether an affiliated group of corporations having properly filed a consolidated return may, on or before the due date of such return, file their returns on a separate basis.

Section 1.1502–10(a) of the Income Tax Regulations, T. D. 6140,[1] provides in part as follows:

> (a) *When privilege must be exercised.*—The privilege of making a consolidated return under section 1502 for any taxable year of an affiliated group must be exercised at the time of making the return of the common parent corporation for such year. For this purpose, the return is considered as made on the due date of such return (including any extensions of time granted by the Commissioner), regardless of the actual previous date of filing. Under no circumstances can such privilege be exercised at any time thereafter. The filing of separate returns for a taxable year does not constitute an election binding upon the corporation in subsequent years. If the privilege is exercised at the time of making the return, separate returns cannot thereafter be made for such year. * * *

Under section 1.1502–10(b) of the Regulations, it is provided that in no case will the privilege under paragraph (a) be considered as exercised at the time of making a so-called "tentative return" made, for example, in order to obtain an extension of time for making the return required by law.

I. T. 2535, C. B. IX–1, 125 (1930), holds that separate returns filed by a husband and wife before the last day for filing such returns should be accepted as properly substituted for a joint return previously filed. Also see I. T. 3775, C. B. 1946–1, 76, and G. C. M. 21227, C. B. 1939–1 (Part 1), 191. The principles set forth in the above cited rulings are equally applicable to the present question.

For example, a group of affiliated corporations on a calendar year basis properly elected and filed a consolidated return for 1954 on March 15, 1955. Revenue Ruling 55–174, C. B. 1955–1, 141, extended, to September 15, 1955, the time for filing such returns. Therefore, the members of the affiliated group, on or prior to such date, could have properly filed their returns on a separate basis.

Accordingly, where an affiliated group of corporations has an election to make either consolidated or separate returns and has properly filed a consolidated Federal income tax return for a taxable year, the members of the affiliated group may file their returns on a separate basis on or before the due date of such returns, including any extension of time granted by the Commissioner, provided the payments theretofore made and to be made are adjusted in a manner satisfactory to the Commissioner. Similarly, a consolidated return may properly be filed on or before the due date notwithstanding the earlier filing of separate returns.

SECTION 1502.—REGULATIONS

26 CFR 1.1502–11: Consolidated returns for subsequent years. Rev. Rul. 56–68

Neither the repeal of sections 452 and 462 of the Internal Revenue Code of 1954 on June 15, 1955, nor the promulgation of the regulations governing consolidated Federal income tax returns on August 29, 1955, gave rise to the privilege of making a new election to file separate returns for the calendar year 1955 by an affiliated group of corporations which filed a consolidated return for the calendar year

[1] T. D. 6140, C. B. 1955–2, 317 at 323.

1954 on or before September 15, 1955. Consequently, an affiliated group which filed a consolidated return for the calendar year 1954, or for the first taxable year ending after August 16, 1954, must, therefore, file a consolidated return for the calendar year 1955 or the fiscal year ending in 1955 or 1956 unless a new election is made available under the provisions of section 1.1502–11 of the Income Tax Regulations.

Advice has been requested whether an affiliated group of corporations which filed a consolidated return for the calendar year 1954 on or prior to September 15, 1955, may elect to file separate returns for the calendar year 1955 by reason of the retroactive repeal of sections 452 and 462 of the Internal Revenue Code of 1954.

Sections 452 and 462 of the 1954 Code were repealed on June 15, 1955, for all taxable years beginning after December 31, 1953, and ending after August 16, 1954, by Public Law 74, 84th Cong., 1st Sess., 69 Stat. 136, C. B. 1955–2, 748. Income tax regulations relating to consolidated returns were promulgated on August 29, 1955, as Treasury Decision 6140, C. B. 1955–2, 317.

Section 1.1502–11 of the Income Tax Regulations, *supra*, provides, in part, as follows:

CONSOLIDATED RETURNS FOR SUBSEQUENT YEARS. * * * If a consolidated return is made under section 1502 for any taxable year, a consolidated return must be made for each subsequent taxable year during which the affiliated group remains in existence unless (1) a corporation (other than a corporation created or organized, directly or indirectly, by a member of the group) has become a member of the group during such subsequent taxable year, or (2) subsequent to the exercise of the election to make consolidated returns, subtitle A of the Code to the extent applicable to corporations, or the regulations under section 1502 which have been consented to, have been amended and any such amendment is of a character which makes substantially less advantageous to affiliated groups as a class the continued filing of consolidated returns, regardless of the effective date of such amendment, or (3) the Commissioner, prior to the time of making the return, upon application made by the common parent corporation and for good cause shown, grants permission to change. For the purpose of (2), above, the expiration of a provision shall be considered as an amendment to the Code made on the date of such expiration.

Affiliated corporations were granted a new election to file separate returns for the first taxable year for which returns were due to be filed after the date of enactment of the 1954 Code and for the first taxable year ending after the date of such enactment. See Rev. Rul. 54–365, C. B. 1954–2, 13.

The time for filing a return for a taxable year ending on or after December 31, 1954, but before June 30, 1955, by a corporation which is a member of an affiliated group having the privilege of making a consolidated return for such taxable year was extended to September 15, 1955. See Rev. Rul. 55–174, C. B. 1955–1, 141.

Section 1.1502–10 of the Income Tax Regulations, *supra*, provides, in part, as follows:

(a) *When privilege must be exercised.* The privilege of making a consolidated return under section 1502 for any taxable year of an affiliated group must be exercised at the time of making the return of the common parent corporation for such year. For this purpose, the return is considered as made on the due date of such return (including any extensions of time granted by the Commissioner), regardless of actual previous date of filing * * *.

Section 1.1502–1(a) of the Income Tax Regulations provides that the privilege of making a consolidated return is given upon the con-

dition that all corporations, which have been members of the affiliated group at any time during the taxable year for which the return is made, consent to the regulations under section 1502 applicable to such taxable year and any amendments thereof duly prescribed prior to the last day prescribed by law for the filing of the return. The making of the consolidated return is considered as such consent.

In view of the fact that the repeal of sections 452 and 462 of the 1954 Code, and the issuance of regulations under section 1502 of the 1954 Code relating to consolidated returns, occurred prior to the date on which the election to make consolidated returns was required to be exercised, neither event gave rise to a new election for subsequent years. Neither the provisions of the 1954 Code nor the consolidated return regulations which are applicable to taxable years beginning after December 31, 1953, and ending after August 16, 1954, have been further amended since September 15, 1955, so as to make substantially less advantageous to affiliated groups as a class the continued filing of consolidated returns for subsequent years.

Accordingly, it is held that neither the repeal of sections 452 and 462 of the 1954 Code nor the promulgation of the regulations governing consolidated Federal income tax returns gave rise to the privilege of making a new election to file separate returns for the calendar year 1955 by an affiliated group of corporations which filed a consolidated return for the calendar year 1954 on or before September 15, 1955. Consequently, an affiliated group of corporations which filed a consolidated return for the calendar year 1954 or for the first taxable year ending after August 16, 1954, must, therefore, file a consolidated return for the calendar year 1955 or the fiscal year ending in 1955 or 1956, whichever is applicable, unless a new election is made available under the provisions of section 1.1502–11 of the Income Tax Regulations.

Rev. Rul. 56–271

Where a member of an affiliated group of corporations which filed a consolidated income tax return for 1954, purchased in 1955, all the stock of another corporation which was not organized "directly or indirectly" by any member of the affiliated group, and subsequently receives the assets of the acquired corporation in a complete liquidation thereof, the acquired corporation becomes a member of the affiliated group within the meaning of section 1.1502–11(a)(1) of the Income Tax Regulations, during the period of its existence, provided the new corporation was acquired for a business purpose not for the principal purpose of acquiring the right of a new election to file separate returns. Under such circumstances the members of the affiliated group may elect to file separate returns.

Advice has been requested whether an affiliated group of corporations which had filed consolidated income tax returns may elect, under the circumstances described below, to file separate income tax returns.

In April, 1955, *O* corporation, a subsidiary corporation and a member of an affiliated group of corporations which filed a consolidated income tax return for the fiscal year ended September 30, 1954, purchased for cash all the stock of *P* corporation. *P* was not a corporation created or organized, directly or indirectly, by a member of the affiliated group. Acquisition of control of *P* by *O* was motivated by a business purpose, as evidenced by the fact that certain production contracts entered into by *O* were to be completed in 1955, and it was considered necessary to find a business activity to take the place of

the production being terminated. On June 30, 1955, the property of *P* was distributed to *O* in complete liquidation under the provisions of section 334(b)(2) of the Internal Revenue Code of 1954.

Section 1.1502–11 of Income Tax Regulations provides, in part, as follows:

(a) CONSOLIDATED RETURNS REQUIRED FOR SUBSEQUENT YEARS.—If a consolidated return is made under section 1502 for any taxable year, a consolidated return must be made for each subsequent taxable year during which the affiliated group remains in existence unless (1) a corporation (other than a corporation created or organized, directly or indirectly, by a member of the group) has become a member of the group during such subsequent taxable year, * * *.

Under the facts, it is evident that the acquisition of the stock and the liquidation of the acquired corporation were for bona fide business purposes and were not for the principal purpose of acquiring the right of a new election to file separate returns.

Accordingly, it is held that where a member of an affiliated group of corporations which filed a consolidated income tax return for 1954, purchased in 1955, all the stock of another corporation which was not organized "directly or indirectly" by any member of the affiliated group, and subsequently receives the assets of the acquired corporation in a complete liquidation thereof, the acquired corporation becomes a member of the affiliated group within the meaning of section 1.1502–11(a)(1) of the Income Tax Regulations, during the period of its existence, provided the new corporation was acquired for a business purpose, not for the principal purpose of acquiring the right of a new election to file separate returns. Under such circumstances the members of the affiliated group may elect to file separate returns.

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26 CFR 1.1502–31: Bases of tax computation. Rev. Rul. 56–186
(Also Sections 453, 1231.)

A promissory note, received by a parent corporation for the sale of real property used in its business, was sold by the corporation to one of its subsidiaries for cash in the amount of the unpaid balance of the note. The gain on the sale of the real property qualified for treatment under section 1231 of the Internal Revenue Code of 1954 as gain on the sale of a capital asset by the parent corporation. That corporation elected to report such gain on the installment basis as provided in section 453 of the 1954 Code. The parent and subsidiary corporation filed a consolidated income tax return for the taxable year in which the note was sold to the subsidiary. Under section 1.1502–31(b)(1)(i) of the Income Tax Regulations, the gain to the parent corporation, represented by the difference between its cost basis of the note sold and the amount paid therefor by the subsidiary, is an intercompany profit to be eliminated from the net income reported in a consolidated return for that taxable year. Under section 1.1502–38(b) of the Regulations, the basis of the note in the hands of the subsidiary is the same as in the hands of the parent corporation. The profit on the collections on the note is considered a gain to the subsidiary from the sale of a capital asset as provided in section 1231 of the Code, the same as it would have been in the hands of the parent corporation. Because the parent corporation had elected to report the gain realized from payments received on the note on the installment basis, the subsidiary is required to continue to report such gain on the same basis.

SECTION 1503.—COMPUTATION AND PAYMENT OF TAX

26 CFR 1.1503–1: Computation and payment of tax. Rev. Rul. 56–128

> Subsidiary corporations engaged in the freight forwarding business, within the meaning of section 1002(a)(5) of Title 49 of the United States Code, and which derive at least 80 percent of their gross income, computed without regard to dividends and capital gains and losses, from the furnishing of such services qualify as regulated public utilities under section 1503(c) of the Internal Revenue Code of 1954.

Advice has been requested whether certain subsidiary corporations which are freight forwarders constitute regulated public utilities within the meaning of section 1503(c) of the Internal Revenue Code of 1954.

Subsidiary corporations, *X* and *Y*, are freight forwarders. They utilize common carriers by railroad, motor vehicles, and water, or a combination thereof, in rendering their services to shippers. The rates charged by each subsidiary for the furnishing of such services have been established or approved by the United States Interstate Commerce Commission, and each holds a permit from that Commission to perform freight forwarding services, from which they derive 80 percent or more of their gross income, exclusive of dividends and capital gains and losses.

Section 1002(a)(5) of Title 49, United States Code, defines a freight forwarder as follows:

> The term "freight forwarder" means any person which (otherwise than as a carrier subject to chapters 1, 8 or 12 of this title) holds itself out to the general public as a common carrier to transport or provide transportation of property, or any class or classes of property, for compensation, in interstate commerce, and which, in the ordinary and usual course of its undertaking, (A) assembles and consolidates or provides for assembling and consolidating shipments of such property, and performs or provides for the performance of break-bulk and distributing operations with respect to such consolidated shipments, and (B) assumes responsibility for the transportation of such property from point of receipt to point of destination, and (C) utilizes, for the whole or any part of the transportation of such shipments, the service of a carrier or carriers subject to chapters 1, 8, or 12 of this title.

Section 1503(c)(1) of the Internal Revenue Code of 1954 defines a regulated public utility, as far as is pertinent here, as follows:

> (A) A corporation engaged in the furnishing or sale of—
>
> * * * * * * *
>
> (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.

Section 1503(c)(2) of the Code provides that for the purpose of computing the tax on a consolidated return the term "regulated public utility" does not include a corporation which does not receive at least 80 percent of its income, computed without regard to dividends and capital gains and losses, from "regulated public utility" sources as defined in section 1503(c)(1) of the Code.

Accordingly, since the subsidiary corporations are engaged in the freight forwarding business within the meaning of section 1002(a)(5) of Title 49 of the United States Code and derive at least 80 percent of their gross income, computed without regard to dividends and capital gains and losses, from the furnishing of such services, it is held that they qualify as regulated public utilities under section 1503(c) of the Internal Revenue Code of 1954.

SECTION 1504.—DEFINITIONS

26 CFR 1.1504–1: Definitions.

Consolidated return involving subsidiaries whose stocks were less than 95 percent owned by a parent for years prior to 1954, but were more than 80 percent owned by such parent after 1953. See Rev. Rul. 56–34, page 436.

SUBTITLE B.—ESTATE AND GIFT TAXES

CHAPTER 11.—ESTATE TAX

SUBCHAPTER A.—ESTATE OF CITIZENS OR RESIDENTS

PART III.—GROSS ESTATE

SECTION 2032.—ALTERNATE VALUATION

Rev. Rul. 56–60

Where the value of the decedent's gross estate at the date of death does not exceed the statutory exemption of $60,000, a Federal estate tax return, Form 706, filed with respect to the estate is not a return as contemplated by section 6018(a)(1) of the Internal Revenue Code of 1954. Consequently, an election to apply the alternate valuation provisions contained in section 2032 of the 1954 Code is not authorized.

The Internal Revenue Service has received numerous inquiries whether the rule expressed in Revenue Ruling 55–333, C. B. 1955–1, 449, may be applied where the value of the decedent's gross estate at the date of death is less than the statutory exemption of $60,000.

In Revenue Ruling 55–333, *supra*, it was held that section 811(j) of the Internal Revenue Code of 1939 (section 2032 of the Internal Revenue Code of 1954) does not limit the application thereof to the estates of decedents which have decreased in value during the one-year period following the date of death. Consequently, where an estate has increased in value during that period of time and the executor has elected, on a timely filed return, to have the estate valued in accordance with the provisions of section 811(j), all property included in the gross estate which has not been distributed, sold, exchanged, or otherwise disposed of within one year after the decedent's death, shall be valued as of the date one year after the decedent's death. Property distributed, sold, exchanged, or otherwise disposed of within one year after the decedent's death shall be valued as of the date of such distribution, sale, exchange, or other disposition.

Section 6018(a)(1) of the Internal Revenue Code of 1954 specifies that the executor shall, in the case of a citizen or resident, file an estate tax return where the gross estate of a decedent at the date of death exceeds $60,000. Section 2032 of the 1954 Code provides that the election to value the gross estate of the decedent as of one year after the date of death or as of an intermediate date must be made by the executor on the estate tax return. Accordingly, it is held that where the value of the decedent's gross estate at the date of death does not exceed the statutory exemption of $60,000, a Federal estate tax return, Form 706, filed with respect to the estate is not a return as contemplated by section 6918(a)(1) of the Code. Because the return will not be recognized for Federal estate tax purposes, it follows that any material contained therein would have no force or effect with respect to its application in the determination of any other Federal tax liability. Consequently, an election to apply the alternate valuation provisions contained in section 2032 of the 1954 Code is not authorized.

SECTION 2039.—ANNUITIES

Rev. Rul. 56-1

Where an individual who is covered by the United States Civil Service Retirement System dies before retirement, the amount includible in his gross estate under section 2039 of the Internal Revenue Code of 1954 on account of an annuity payable to his surviving spouse, or other beneficiary, is the amount of the decedent's contribution to the system.

Advice has been requested as to the amount includible in the decedent's gross estate under section 2039 of the Internal Revenue Code of 1954 on account of an annuity payable to his surviving spouse under the United States Civil Service Retirement System.

At the time of his death the decedent was employed by the United States Government. He was survived by his wife who became entitled to an immediate annuity of $200.00 a month, the present value of which was $36,000.

Section 2039(a) of the Internal Revenue Code of 1954 provides for the inclusion in the decedent's gross estate of the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement (other than insurance on the decedent's life) if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or other payment for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.

Section 2039(b) provides that subsection (a) shall apply to only such part of the value of the annuity or other payment receivable under such contract or agreement as is proportionate to that part of the purchase price therefor contributed by the decedent and, for the purposes of this section, any contribution by the decedent's employer shall be considered to be contributed by the decedent if made by reason of his employment.

Section 2039(c) provides, however, that there shall be excluded from the gross estate the value of an annuity or other payment receivable by any beneficiary (other than the executor) under "an employees'

trust * * * forming part of a pension * * * plan which, at the time of the decedent's separation from employment (whether by death or otherwise), * * * met the requirements of section 401(a)" except that "if such amounts * * * are attributable to any extent to payments or contributions made by the decedent, no exclusion shall be allowed for that part of the value of such amounts in the proportion that the total payments or contributions made by the decedent bears to the total payments or contributions made." For the purposes of subsection (c), contributions made by the decedent's employer shall not be considered to be contributed by the decedent.

The United States Civil Service Retirement System is treated as an employees' trust which has been held to meet the requirements of section 165(a) of the Internal Revenue Code of 1939 (section 401(a) of the Internal Revenue Code of 1954).

The decedent contributed $5,000 to the United States Civil Service Retirement System and the interest accrued thereon to the date of his death amounted to $3,000. The accrued interest is considered as attributable to payments or contributions made by the decedent.

The report of the Senate Finance Committee on section 2039 of the 1954 Code states that where the annuity is payable out of a fund or under a plan where the employer's contribution to a particular employee's account cannot be readily ascertained, the total contributions may, in the absence of a more precise method of determination, be considered to be the value of the annuity payable to the decedent and the survivor as of the time such annuity becomes fixed. The amount contributed by the Government to the purchase of the employee's or the survivor's retirement annuity is not readily ascertainable.

As the decedent in the instant case died before retirement, the value of the annuity payable to his wife which became fixed as of the date of his death is considered to be the value of the total contributions. Accordingly, the amount includible in decedent's gross estate on account of the annuity payable to his wife is computed as follows:

$$\frac{\text{Decedent's contribution } \$8{,}000}{\text{Total contributions } 36{,}000} \times \$36{,}000 \text{ (Value of annuity)} = \$8{,}000$$

It is thus apparent that where an individual who is covered by the United States Civil Service Retirement System dies before retirement, the amount includible in his gross estate under section 2039 of the Internal Revenue Code of 1954 on account of an annuity payable to his surviving spouse, or other beneficiary, is the amount of the decedent's contribution to the system plus the interest accrued thereon.

PART IV.—TAXABLE ESTATE

SECTION 2053.—EXPENSES, INDEBTEDNESS, AND TAXES

Rev. Rul. 56–290

Where income received by the decedent is included in a joint income tax return filed by the decedent's estate and his surviving spouse, the amount of income tax attributable to the decedent's income for the purpose of determining the amount allowable as a deduction under section 2053 of the Internal Revenue Code of 1954

shall be considered to be that proportion of the joint tax liability determined for the period covered by the joint return which the amount of income tax for which the decedent would have been liable if he had filed a separate return for that period bears to the total amount of income tax for which the decedent and his spouse would have been liable if both spouses had filed separate returns for that period.

Revenue Ruling 54–382, C. B. 1954–2, 279, modified.

The Internal Revenue Service has been asked to reconsider Revenue Ruling 54–382, C. B. 1954–2, 279, insofar as it relates to the amount of income tax allowable as a deduction from the decedent's gross estate where the decedent's executor and his widow file a joint return for the year in which he died.

Revenue Ruling 54–382, *supra*, holds that for the purpose of determining the amount allowable as a deduction under section 812(b) of the Internal Revenue Code of 1939 (section 2053 of the Internal Revenue Code of 1954) the amount of income tax attributable to the decedent's income, in the case of a joint income tax return filed by the decedent's estate and his surviving spouse, is that portion of the total income tax shown on the joint return that the amount of the decedent's net income, less his exemption, bears to the total net income, less the total exemptions allowed.

The method of allocating that portion of the total income tax attributable to the decedent's income for the period ending with his death for the purpose of determining the amount allowable as a deduction under section 2053 of the 1954 Code, has been reconsidered by the Internal Revenue Service. It has been found that in applying the method of allocating the tax enunciated in Revenue Ruling 54–382, *supra*, the amount of the total tax attributable to the decedent does not truly reflect that portion of the total tax attributable to his separate income.

In view of the foregoing, it is held that where income received by the decedent during his lifetime is included in a joint income tax return filed by the decedent and his spouse, or by the decedent's estate and the surviving spouse, the decedent's income tax liability for the period covered by the return shall be considered to be that proportion of the joint tax liability determined for that period which *A* (the amount of income tax for which the decedent would have been liable if he had filed a separate return for that period) bears to *B* (the total of the amount for which the decedent would have been liable and the amount for which the spouse would have been liable if both spouses had filed separate returns for that period). The deduction allowable for the amount remaining unpaid for the period covered by the return shall not exceed the lesser of (1) the decedent's liability for the period (as determined in the preceding sentence), reduced by the amounts already contributed by the decedent toward payment of the joint liability, or (2) in the event there is an agreement between the decedent and his spouse or between the executor and the spouse relative to the payment of the joint liability, the amount which pursuant to the agreement is to be contributed by the estate toward payment of the joint liability.

To the extent that it is inconsistent herewith, Revenue Ruling 54–382, C. B. 1954–2, 279, is hereby modified.

SECTION 2056.—BEQUESTS, ETC., TO SURVIVING SPOUSE

Rev. Rul. 56-26

While amounts allowed for the support of the surviving spouse during the period of settlement of the deceased spouse's estate may otherwise constitute a nondeductible interest under section 2056(b) of the Internal Revenue Code of 1954, such amounts may nevertheless qualify for the estate tax marital deduction to the extent that all or any part of the residuary estate of the decedent passed from the decedent to his surviving spouse by intestacy or as beneficiary under his will.

Advice has been requested whether amounts paid to a surviving widow as an allowance for support will qualify for the marital deduction authorized by section 2056 of the Internal Revenue Code of 1954 under the circumstances set forth below.

The decedent died testate leaving his entire probate estate to his surviving wife. Pursuant to an order of the local probate court, the widow was entitled to an allowance for support during the period of settlement of the deceased spouse's estate.

Revenue Ruling 83, C. B. 1953-1, 395, sets forth the general rule to be followed in such cases. Such rule is to the effect that, in order to qualify for the marital deduction, a property interest in the form of an allowance made, pursuant to local law, for the support of the decedent's spouse, must be a vested right of property, such as will, in the event of the spouse's death as of any moment or time following the decedent's death, survive as an asset of her estate. Otherwise, such allowance constitutes a terminable interest within the meaning of section 2056(b) of the 1954 Code and, as such, does not qualify for the deduction.

The terminable interest rule of section 2056(b) does not apply, however, unless (1) an interest in the property also passed from the decedent (whether by will or under local law) to someone other than his surviving spouse, *or the estate of such spouse*, and (2) by reason of such passing such other person may possess or enjoy such property after the termination or failure of the interest therein which passed to the surviving spouse. Thus, assume a case where a decedent leaves property to his widow for life, with remainder to her estate (executors or administrators). The life estate given is clearly a terminable interest, but as no interest in the property passed to anyone other than the widow, or the estate of the widow, the rule set forth in section 2056(b) does not apply and the entire interest qualifies for the marital deduction.

The same would apply in respect of the interest of the instant decedent's widow in the form of her support allowance. Since the decedent left her his entire probate estate, no interest in the amounts awarded for her support during the settlement of the estate may, for the purposes of section 2056, be considered as having passed to any person other than his spouse, or the estate of such spouse. In other words, while the widow's death at any time following the decedent's death would have terminated her right to any further support allowance, any amounts remaining unpaid would, nevertheless, become a

part of the residuary estate and, as such, would pass to her estate under the terms of her husband's will. Thus, the requirement of section 2056 of the statute, as more particularly set forth in Revenue Ruling 83, *supra*, has been met, and the marital deduction is allowable.

So long as the interest passing to the surviving spouse, when viewed as of the decedent's death, is an indefeasibly vested interest, it is immaterial whether the statutory requirement in the foregoing respect is satisfied by reason of the applicable provisions of the local law, by reason of the terms of the decedent's will, or otherwise. Therefore, the same rules would apply in the case of an intestate share in the decedent's estate. For example, if the decedent died intestate and one-third of his estate passed to his surviving spouse as absolute owner under the intestacy laws of the jurisdiction, then one-third of any amounts paid out of the estate, pursuant to local law, for the support of such spouse, is a deductible interest since, to that extent, it in effect merely represents an advancement from property which is already indefeasibly hers, and will pass to her, or to her estate, in any event.

In view of the foregoing, it is held that while amounts allowed for the support of the surviving spouse during the period of settlement of the deceased spouse's estate may otherwise constitute a nondeductible interest under section 2056(b) of the Internal Revenue Code of 1954, such amounts may nevertheless qualify for the estate tax marital deduction to the extent that all or any part of the residuary estate of the decedent passed from the decedent to his surviving spouse by intestacy or as beneficiary under his will.

SUBCHAPTER B.—ESTATES OF NONRESIDENTS NOT CITIZENS

SECTION 2105.—PROPERTY WITHOUT THE UNITED STATES

(Also Section 2106.) Rev. Rul. 56–52

An ambassador, or other diplomatic officer of a foreign country, duly accredited to the United States, is not considered, for estate tax purposes, as having been engaged in business in the United States at the time of his death solely by reason of his activities in this country in connection with the formal representation of his government as an accredited diplomat. Consequently, any moneys deposited with any person carrying on the banking business by or for the ambassador, or other diplomatic officer of a foreign country, who at the time of his death is neither domiciled in nor a national of the United States, and obligations of the United States issued prior to March 1, 1941, owned by such person, are exempt from the Federal estate tax under the provisions of sections 2105(b) and 2106(c), respectively, of the Internal Revenue Code of 1954, provided he is not otherwise engaged in business in the United States at the time of his death. Compare Revenue Ruling 187, C. B. 1953–2, 291, which held that the estate tax is not applicable to personal property used by a foreign envoy duly accredited to the United States in the conduct of his official mission and reasonably

required for such purpose. This ruling is not to be construed as having any effect upon a determination of the trade or business of an ambassador or other diplomatic officer of a foreign country for Federal income tax purposes. See section 871 of the Code.

SECTION 2106.—TAXABLE ESTATE

Application of the Federal estate tax in the case of a diplomatic officer of a foreign country. See Rev. Rul. 56–52, above.

CHAPTER 12.—GIFT TAX

SUBCHAPTER A.—DETERMINATION OF TAX LIABILITY

SECTION 2503.—TAXABLE GIFTS

Rev. Rul. 56–86

Under a statute adopted by the State of Colorado and a number of other states, securities, other than those in bearer form, transferred to a minor donee pursuant to an express provision thereof, are required to be registered in the name of the donor, the name of any adult member of the minor's family, or in the name of the minor's guardian as custodian for the minor. Securities in bearer form must be delivered to an adult member of the minor's family, other than the donor, as custodian, accompanied by a deed of gift. Under the provisions of such statute, a transfer of securities to a minor donee in the manner prescribed therein irrevocably conveys to the minor indefeasibly vested legal title to the securities. The custodian is authorized to apply so much of the income or principal of the property held by him, as custodian, for the support, maintenance, education, and general use and benefit of the minor, in such manner, at such time, and to such extent as he, in his sole discretion, deems suitable and proper. Any property and the income thereof not so expended shall be delivered or paid to the minor upon the minor's reaching the age of 21 years. If the minor dies before reaching the age of 21 years, the property and accumulated income therefrom is to be delivered to the minor's estate. *Held*, a transfer of securities to a minor donee pursuant to the statute adopted by the State of Colorado constitutes a completed gift for Federal gift tax purposes at the time the transfer was made. *Held further*, such gifts come within the purview of section 2503(c) of the Internal Revenue Code of 1954 and, therefore, qualify for the annual gift tax exclusion authorized by section 2503(b) of the Code. Compare Revenue Ruling 54–400, C. B. 1954–2, 319, which held that a gift of property does not constitute a gift of a future interest merely because the donee is a minor. The income tax consequences of such a transfer are still under consideration by the Internal Revenue Service.

SUBTITLE C.—EMPLOYMENT TAXES

CHAPTER 21.—FEDERAL INSURANCE CONTRIBUTIONS ACT

SUBCHAPTER C.—GENERAL PROVISIONS

SECTION 3121.—DEFINITIONS

Rev. Rul. 56-14

Services performed on a farm by employees of a contractor in cleaning and treating seed wheat which is to be planted by the grower thereof constitute "agricultural labor" within the meaning of section 3121(g) of the Federal Insurance Contributions Act. Such cleaning services as are performed on nonfarm areas, services performed in moving, maintaining and repairing the contractor's equipment, and clerical, collection and other similar services relating to his business operations, do not constitute "agricultural labor" within the meaning of that section.

The Internal Revenue Service has been requested to determine whether services performed in connection with treating seed wheat constitute "agricultural labor" within the meaning of section 3121(g) of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954).

It is customary for many farmers to retain sufficient wheat from their threshed wheat crop to serve as seed for the next crop. This seed wheat is held in grain storage bins or in small elevators which may be located either on farm or nonfarm properties.

In the instant case, an individual contracts with farmers to treat their seed wheat for rust, smut, etc. He owns the necessary treating equipment, furnishes the supplies and chemicals used, and hires and pays his own helpers. He transports his treating equipment to the various locations where the seed wheat is stored, treats the seed and receives a fixed fee per bushel of wheat treated. He is not a farmer or wheat grower and does not own, buy, or have any interest in any of the wheat he handles.

Under section 3121(g) of the Act, the term "agricultural labor" includes all service performed—

> (1) on a farm, in the employ of any person, in connection with cultivating the soil, or in connection with raising * * * any agricultural or horticultural commodity, * * *;
>
> (2) in the employ of the owner or tenant or other operator of a farm, in connection with the operation, management, conservation, improvement, or maintenance of such farm and its tools and equipment, * * * if the major part of such service is performed on a farm;

It is the position of the Service that the cleaning or treating of seeds by, or for, the grower thereof, which were obtained by retaining a portion of his crop and which are used exclusively by the grower for planting purposes, are operations of the type contemplated by paragraph (1), section 3121(g), *supra*. Accordingly, such services constitute "agricultural labor" within the meaning of that paragraph when performed "on a farm," without regard to whether the services are performed in the employ of the grower or of a commercial handler.

However, services performed by employees of commercial handlers on nonfarm property in cleaning or treating seeds, or at any location in cleaning or treating seeds which are to be sold, do not come within the meaning of that paragraph. Furthermore, services performed by such employees in moving seed cleaning and treating equipment from one location to another, as well as in maintaining and repairing such equipment, and clerical, collection and other similar services relating to seed cleaning operations conducted by a commercial handler, do not constitute "agricultural labor" within the meaning of paragraph (2), section 3121(g), *supra*.

In accordance with the above-stated position, it is held that services performed on a farm by employees of the contractor in the instant case, in connection with the treating of seed wheat which is to be planted by the grower thereof, constitute "agricultural labor" within the meaning of section 3121(g) of the Federal Insurance Contributions Act. However, services performed by the contractor's employees in treating seed wheat on nonfarm property, services performed in treating seed wheat which is to be sold, services relating to the moving, maintenance and repair of the seed cleaning equipment, and clerical, bookkeeping, supervisory and administrative services relating to his seed treating operations, do not constitute "agricultural labor" within the meaning of that section.

The remuneration for "agricultural labor" received by an employee of the contractor constitutes "wages" if it meets the "$100-a-year" test in section 3121(a)(8)(B) of the Federal Insurance Contributions Act. For examples showing how the test is to be applied, see Revenue Ruling 55–707, C. B. 1955–2, 420. Liability for the taxes imposed by such Act is incurred with respect to such "wages" and with respect to any other "wages" which the employee receives from the contractor for nonagricultural services, subject to the limitation provided by section 3121(a)(1) of that Act.

(Also Section 1402.) Rev. Rul. 56–15

An individual operates a "cash and carry" laundry and dry cleaning agency under an agreement with a laundry firm which picks up, cleans, and returns the laundered articles to her office. The firm furnishes bins, racks, office forms, and a company sign; carries insurance on the articles; regulates the prices to be charged; and notifies the individual of special sales or campaigns. The individual works on a straight commission basis, pays her own business expenses including office rental, regulates her hours of work, determines her work routine and the amount of time to be devoted to the work, and engages and pays her own help. The agreement may be terminated by either party at any time. *Held*, the individual is not an employee of the firm for Federal employment tax purposes.

The individual is engaged in a "trade or business," the income from which must be considered in computing net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954.

Advice has been requested relative to the status, for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954) and the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954), of an individual operating a "cash and carry" laundry agency under an agreement with a laundry firm.

Under the terms of the agreement, the individual provides her own office and storage space, determines her working hours and the amount of time she shall devote to the work, and is not required to perform the services personally, follow a particular routine, or meet quotas. Her activities consist primarily of collecting or receiving, from customers, the articles to be laundered or dry cleaned by the firm, issuing tickets therefor, storing the cleaned articles until called for by customers, and collecting payment therefor when the articles are claimed. She pays all the expenses incurred in the operation of the agency and hires and pays her assistants if and when needed. She is required to adhere to established prices set by the firm and is remunerated on a straight commission basis, such commission being deducted by her prior to her remittance of collections to the firm. The agency is operated in the name of the firm. The bundles of laundry to be cleaned are picked up by the firm's routeman, cleaned, and returned to the individual's place of business three times a week. The firm communicates with her by telephone and through its routeman when the occasion arises, such as when prices are to be changed, special sales or campaigns held, etc., and through occasional visits by other representatives of the firm. The firm furnishes business forms, bins, racks, shelves for the storeroom, and an outside sign and storage box. The firm does not carry any insurance covering the individual but carries fire and theft insurance on the laundry packages. The agreement may be terminated by either party at any time.

Section 3121(d) of the Federal Insurance Contributions Act provides in part that the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The guides for determining whether, under such rules, an employer-employee relationship exists, are found in section 408.204(c) of Regulations 128, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

The determination whether an employer-employee relationship exists depends upon the particular facts in each case. In the instant case, the individual's commissions from the firm depend entirely upon her own efforts in obtaining customers and keeping her office open a reasonable number of hours. While the firm furnishes certain equipment, it does not appear that the value thereof equals or outweighs the value of the premises furnished by the individual, who, in addition, pays all of her own operating expenses. The firm's communications and notices relative to price changes, special sales or campaigns, etc., although essential to the operation of the agency, do not necessarily have a bearing on the right of control or supervision over the individual by the firm. Nor does an occasional visit to the individual's office by the firm's representatives necessarily indicate a right of control or supervision. On the contrary, the firm appears to be interested merely in the results to be accomplished and not in the means and methods for accomplishing those results.

In view of the foregoing, it is concluded that the individual is not subject to such control and direction by the laundry firm as is necessary, under the usual common law rules, to establish an employer-employee relationship for Federal employment tax purposes.

Section 1402 of the Self-Employment Contributions Act of 1954 provides in part:

(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 [subtitle A] which are attributable to such trade or business, * * *.

* * * * * * *

(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 * * *.

As a general rule, when a person is engaged in an occupation or profession for profit which constitutes, in whole or in part, his livelihood, and as to such occupation or profession, is not regarded as an employee for purposes of the taxes imposed by the Federal Insurance Contributions Act or otherwise excluded from the self-employment provisions, he is engaged in a "trade or business" within the meaning of section 1402(c), *supra*.

In the instant case, it is held that the individual is engaged in a "trade or business" in the operation of a "cash and carry" laundry and dry cleaning agency under the circumstances herein involved. The income derived from such activity should be taken into consideration in computing net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954.

(Also Section 3401.) Rev. Rul. 56–35

A partnership enters into oral agreements with farmers to cut their lettuce, pack it in shipping cartons in the field, and haul it to a commercial vacuum cooling plant. *Held*, services performed by the partnership's employees on the farms of its customers in connection with harvesting the lettuce, including cutting the heads, constitute "agricultural labor," as defined in section 3121(g) of the Federal Insurance Contributions Act. *Held further*, services performed in the employ of the partnership, a custom operator, in handling and packing the lettuce, hauling it to the cooling plant, repairing and maintaining equipment, as well as clerical and administrative services relating to such operations, do not constitute "agricultural labor."

Advice has been requested whether services performed in the employ of a partnership, a custom operator, in handling and packing lettuce in shipping cartons on the farms of its customers are a part of the harvesting operation and whether these and other services constitute "agricultural labor" as defined in section 3121(g) of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954).

Formerly, lettuce could not be packed in cardboard boxes in the field because it had to be iced while being packed. Now, with the vacuum cooling process, the lettuce can be field-packed in shipping cartons, hauled to a commercial vacuum cooling plant, cooled and shipped. The cartons are factory-made, of cardboard, in one flat piece, and bear the name and label of the lettuce grower.

No lettuce is raised by the partnership. It enters into oral agreements with growers to field-pack their lettuce. A grower specifies

the number of cartons and the kind of lettuce he wants packed each day, and pays the partnership a set contract price for the number of cartons packed.

The partnership hires and pays its own crew to perform the following services: The truck drivers pick up the grower's flat cartons and take them to the field, where they are unloaded, assembled (flaps folded and stapled), and distributed by hand along the rows of lettuce. Other crew members cut the heads of lettuce and leave them on the ground for the packers. The packers fill the cartons as they move along. Then men with portable staple guns follow the packers and close and staple the top flaps of the cartons. Then the truckers drive through the fields, load the packed cartons, and take them to the vacuum cooling plant. Other than the trucks and tractors used to collect and deliver cartons and the stapling machines, no machinery is used in connection with this packing operation. All of the lettuce is packed for marketing purposes and is shipped in the same cartons in which it left the field.

As defined in section 3121(g) of the Federal Insurance Contributions Act, the term "agricultural labor" includes all service performed—

> (1) on a farm, in the employ of any person, in connection with cultivating the soil, or in connection with raising or harvesting any agricultural or horticultural commodity * * *;
>
> * * * * * * *
>
> (4)(A) in the employ of the operator of a farm in handling, planting, drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market, in its unmanufactured state, any agricultural or horticultural commodity; but only if such operator produced more than one-half of the commodity with respect to which such service is performed;

The question is whether the handling and packing services performed by employees of the partnership are so closely related to the harvesting operation as to be considered an integral part of harvesting and therefore an operation of the character contemplated by paragraph (1) rather than paragraph (4) of section 3121(g), *supra*.

It is held that handling and packing lettuce for shipment to market, even though done in the field immediately after the cutting, are not a part of the harvesting operation. These are post-harvesting operations of the character contemplated by paragraph (4) of section 3121(g) of the Act. Moving the operations from the icing plant (where they were done formerly) to the farm does not change their character. To hold that these operations are an integral part of harvesting would be to transcend the scope of operations specifically enumerated in paragraph (4).

As indicated by that part of paragraph (4) of section 3121(g) quoted [above,] the services enumerated therein constitute "agricultural labor" only if performed in the employ of the operator of a farm and such operator produced more than one-half of the commodity handled in a pay period. The "operator of a farm" means an owner, tenant, or other person, in possession of a farm and engaged in the operation of such farm. Thus, if the partnership in the instant case were the operator of the farm or farms on which more than one-

half of the lettuce handled in a pay period was produced, the services of its employees in handling and packing the lettuce would constitute "agricultural labor." See Rev. Rul. 174, C. B. 1953–2, 299.

However, the partnership involved here is not the operator of the farms on which more than one-half of the lettuce handled in a pay period was produced. Therefore, none of the services performed by its employees in handling and packing the lettuce, or in picking up cartons, assembling, distributing and sealing them, and in transporting them to the vacuum cooling plant, constitute "agricultural labor" within the meaning of section 3121(g) of the Act. Moreover, none of the services performed in connection therewith, such as maintenance and repair of trucks and other equipment, or clerical or administrative services relating to such operations, constitute "agricultural labor" within the meaning of such section.

Services performed by the partnership's employees on the farms of its customers in connection with cultivating the soil, or in connection with raising or harvesting the lettuce, including cutting the heads, constitute "agricultural labor" as defined in section 3121(g)(1) of the Federal Insurance Contributions Act.

Liability for the taxes imposed by the Federal Insurance Contributions Act is incurred by the partnership with respect to the remuneration paid for the services described herein to the extent that such remuneration constitutes "wages" as defined in section 3121(a) of the Act. The "$100-a-year" test is applicable in determining whether or not remuneration for "agricultural labor" constitutes "wages" for purposes of such taxes. See paragraphs (9) and (10) of Revenue Ruling 55–707, C. B. 1955–2, 420.

Remuneration paid for "agricultural labor," as defined in the Federal Insurance Contributions Act, is excluded from "wages," as defined in section 3401(a) of chapter 24 of the Internal Revenue Code of 1954 (collection of Income Tax at Source on Wages), for purposes of the income tax withholding under section 3402 of the Code. For the application of the rules relating to "included and excluded wages" in determining whether all, or none, of an employee's remuneration for a pay period shall be deemed to be "wages" subject to the income tax withholding, see paragraph (11) of Revenue Ruling 55–707, C. B. 1955–2, 420.

Rev. Rul. 56–36

A beneficiary (a cestui que trust) who manages trust property on behalf of himself and the other beneficiary thereof is not an employee of the trust company which acts as trustee and holds title to the property, where the trustee has no right to control or manage the property.

The Internal Revenue Service has been requested to determine, for Federal employment tax purposes, the status of a managing beneficiary of trust property held by a trust company as trustee.

A trust company holds legal title to a building which was conveyed to it as trustee by *A* and *B* for their benefit. Under the terms of the trust agreement *A* and *B*, as beneficiaries, have the sole right

to control and manage the property, including the collection and disposition of the rents. The trust company is required, under the terms of the trust agreement, to dispose of the property remaining in the trust at the end of the trust period and to divide the proceeds among those entitled to receive them under such agreement. The trust company receives a fixed annual fee for its services.

A manages the property under an agreement with *B*. He hires all necessary labor, contracts for repairs, collects the rents, deposits them in a checking account in his name, and pays all expenses in connection with the management of the property. *A* receives a commission of five percent of the gross rents collected. At the end of each month, *A* and *B* divide the net income from the property on the basis of their respective interests in the trust.

Section 3121(d) of the Federal Insurance Contributions Act (chapter 21, subtitle C, of the Internal Revenue Code of 1954) provides, among other things, that the term "employee" means any individual who under the usual common rules applicable in determining the employer-employee relationship has the status of an employee. Whether the relationship of employer and employee exists under the usual common law rules is largely a question of fact to be determined upon the particular facts of each case. Generally, such relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.

In the instant case, the facts show that the trust company, acting in its capacity as trustee, does not exercise or have the right to exercise any control over the services performed by *A* in connection with the management of the trust property. It is concluded, therefore, that the relationship of employer and employee, for Federal employment tax purposes, does not exist between the trust company as trustee and *A* with respect to such services. Accordingly, the trust company incurs no liability, for such purposes, with respect to the remuneration received by *A* for managing the trust property.

(Also Section 3306.) Rev. Rul. 56–53

A company is engaged in the operation of an alfalfa processing plant. Employees of the company perform services in dehydrating alfalfa grown on its farm, mixing the alfalfa with other ingredients, and grinding the mixture into a feed for sale to livestock feeders. *Held*, such services do not constitute "agricultural labor" within the meaning of section 3121(g)(4)(A) of the Federal Insurance Contributions Act or section 3306(k)(4) of the Federal Unemployment Tax Act.

The Internal Revenue Service has been requested to determine whether services performed by employees of a company in connection with the operation of an alfalfa processing plant constitute "agricultural labor" under section 3121(g)(4)(A) of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954) or section 3306(k)(4) of the Federal Unemployment Tax Act (chapter 23, subtitle C of the 1954 Code).

The company operates an alfalfa processing plant which is used solely for processing alfalfa grown on its farm. The alfalfa is artificially dried at the plant (which is located on the farm where the alfalfa is grown). Then it is mixed with other ingredients and ground into a feed for livestock. All of the feed is sold to livestock feeders.

Services performed by an employee in the processing of alfalfa hay into alfalfa meal and in the handling, packing, packaging, grading, storing, or delivering to storage or to market or to a carrier for transportation to market of alfalfa meal constitute "agricultural labor" under section 3121(g)(4)(A) of the Federal Insurance Contributions Act, provided (1) such services are performed by the employee in the employ of an operator of a farm, (2) such operator is in possession and engaged in the operation of the farm or farms on which more than one-half of the alfalfa handled in a pay period is produced, and (3) such services are performed with respect to the commodity in its unmanufactured state, that is, with respect to the alfalfa meal, nothing else (such as other grains, syrups, etc.) having been added. See section 408.208(d)(5) of Regulations 128, applicable to the provisions of the Internal Revenue Code of 1954 by virtue of T. D. 6091, C. B. 1954–2, 47. Also, in determining whether a person qualifies as an "operator of a farm" under section 3121(g)(4)(A), see Revenue Ruling 174, C. B. 1953–2, 299.

Services performed by an employee in the processing of alfalfa hay into alfalfa meal and in the handling, etc., of alfalfa meal constitute "agricultural labor" under section 3306(k)(4) of the Federal Unemployment Tax Act, provided (1) such services are performed by the employee in the employ of a farmer who produced the alfalfa hay (or in the employ of a farmers' cooperative organization or group whose farmer-members produced the alfalfa hay) and (2) such services are of the character ordinarily performed by the employees of a farmer (or of a farmers' cooperative organization or group) as a prerequisite to the marketing of the alfalfa meal in its unmanufactured state, that is, with nothing else added. See section 403.208(e) of Regulations 107, applicable to the provisions of the 1954 Code by virtue of T. D. 6091, *supra*.

In determining whether the processing services are classifiable as "agricultural labor" under section 3121(g)(4)(A) or section 3306(k)(4), it is immaterial whether the processing plant is located on a farm.

In the instant case, since the company mixes the dried alfalfa with other ingredients, grinds the dried alfalfa and other ingredients into a feed for livestock, and sells the product to livestock feeders, the processing services are not performed with respect to the commodity in its unmanufactured state. Therefore, such services are not performed under the circumstances and conditions necessary to meet the requirements of section 3121(g)(4)(A) of the Federal Insurance Contributions Act or section 3306(k)(4) of the Federal Unemployment Tax Act. Accordingly, it is held (1) that the processing services do not constitute "agricultural labor" for purposes of the taxes imposed by the Federal Insurance Contributions Act and (2) that such services do not constitute "agricultural labor" and are not excepted from "employment" under the provisions of the Federal Unemployment Tax Act.

Rev. Rul. 56–56

A doctor who has completed his internship at one hospital is engaged by another hospital as a resident-in-training for a one-year period. *Held*, inasmuch as the doctor had completed his internship, his services as resident-in-training are not excepted from "employment" under section 3121(b)(13) of the Federal Insurance Contributions Act.

The Internal Revenue Service has been requested to determine the status, for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954), of services performed by a doctor as a resident-in-training for a hospital.

The doctor is a citizen of a foreign country and is a graduate of one of the medical schools of that country. Prior to assuming his duties as a resident-in-training at hospital *A*, he completed his internship at hospital *B*. Both such hospitals are located in this country. Hospital *A* considered the doctor's status to be that of a student during his one-year's residence at that institution and presented him with a diploma at the end of such period.

Under section 3121(b)(13) of the Act, services performed by an individual as an intern (as distinguished from a resident doctor) in the employ of a hospital are excepted from "employment," as that term is defined by the Act, if the medical training of the individual meets certain specified requirements.

Inasmuch as the doctor had completed his internship prior to assuming his duties at hospital *A*, it is concluded that his services as resident-in-training for such hospital are not excepted from "employment" under section 3121(b)(13) of the Act. Accordingly, the remuneration paid to the doctor by hospital *A* constitutes "wages" subject to the taxes under the Act.

The fact that the doctor served his internship in a hospital different from the one in which he serves as a resident-in-training is immaterial. The conclusion for Federal employment tax purposes is the same where the internship and the services as resident-in-training occur at the same hospital.

(Also Section 3401.) Rev. Rul. 56–69

A licensed securities salesman is engaged by an investment firm to sell securities on a commission basis with a guaranteed annual amount of compensation. He is furnished with a private office on the firm's premises and is required to follow its regular office routine and observe its customary working hours. The firm pays for the salesman's license and includes him in several types of insurance which are carried on all its employees. *Held*, the salesman is an employee of the firm for Federal employment tax purposes, including the withholding of income tax.

The Internal Revenue Service has been requested to determine the status, for purposes of the Federal employment taxes, including the withholding of income tax, of a securities salesman who performs services under the conditions and circumstances set forth below.

A partnership is engaged in the business of buying and selling securities as principal and as agent. It sells securities through a salesman who works under an oral agreement which may be terminated at any time by either party. The salesman is licensed by the state to sell securities and is a registered member of a security dealers' organi-

zation. The license and registration fees are paid by the partnership. The salesman is furnished with a private office, stenographic and telephone services, and office supplies. His name appears on the partnership's letterhead and he is required to follow its regular office routine and observe its customary working hours. Generally, the territory covered by the salesman is restricted to the corporate limits of the city, although he occasionally serves customers outside the city. He devises his own methods for locating new customers and uses his own judgment as to the frequency of his calls on regular customers. He makes oral reports on leads occasionally furnished by the partnership, but no reports are required with respect to calls made on regular customers. He is required to adhere to established prices, terms and conditions of sale, and to submit for approval all orders and copies of all letters written by him on behalf of the partnership to any prospect. The salesman has had many years of experience in the business and, therefore, detailed instructions in regard to the performance of his services are unnecessary.

The partnership pays the salesman a percentage of the gross profit on all sales made by him and guarantees him a minimum annual compensation, which is paid in monthly installments. The salesman is covered by workmen's compensation insurance and hospital insurance, and is included in group life insurance carried by the partnership. He performs the services personally, operates under the partnership's name, does not perform services for others, and does not hold himself out to the public as available to do work of a similar or related nature. Orders are solicited by the salesman from individual and institutional investors and the securities are purchased by such customers for investment purposes.

In *Dimmitt-Rickhoff-Bayer Real Estate Co.* v. *Finnegan, Collector of Internal Revenue*, 179 Fed. (2d) 882, certiorari denied, 340 U. S. 823, the court held that the real estate salesmen who performed services under the circumstances and conditions present therein were not employees of the company under the applicable common law rules and that the remuneration paid the salesmen was not subject to Federal employment taxes. The facts in that case show that the salesmen were not required to report at the company's office daily, to keep fixed office hours, or to attend the salesmen's meetings held weekly at the office. The company assisted the salesmen by advice and cooperation, made available to them the facilities of its office and its real estate listings, and furnished them copies of a manual explaining the company's business policies. Each salesman purchased the license required of him by state law and paid the dues for his membership in the local real estate exchange. Commissions earned by each salesman were paid to him monthly. The salesmen were not guaranteed any minimum amount of compensation. By Mimeograph 6566, C. B. 1951–1, 108, that decision was made generally applicable to outside securities salesmen remunerated solely by commissions.

Section 3121(d) of the Federal Insurance Contributions Act (chapter 21, subtitle C, of the Internal Revenue Code of 1954) provides, among other things, that the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The guides for determining whether, under such rules, an employer-employee relationship exists are found in section 408.204(c) of Reg-

ulations 128, applicable to the Internal Revenue Code of 1954 by virtue of T. D. 6091, C. B. 1954–2, 47.

The facts in the instant case are distinguishable from the facts in the Dimmitt-Rickhoff-Bayer case and clearly show the existence of an employment relationship under the usual common law rules. The salesman's name appears on the firm's letterhead and he is guaranteed a minimum amount of compensation, is furnished a private office, and is required to follow the partnership's usual office routine. He is required to submit for approval copies of all letters to prospects written by him on behalf of the partnership. The partnership pays the fees for all licenses which the salesman is required to have for the performance of his services. The salesman is covered by several types of insurance which are carried by the partnership on all of its employees and he performs the services on a full-time basis.

Accordingly, it is held that the partnership exercises or has the right to exercise such control over the salesman in the performance of his services as is necessary under the usual common law rules to establish the relationship of employer and employee for Federal employment tax purposes, including the withholding of income tax.

(Also Section 1402.) Rev. Rul. 56–70

An individual who performs child care services in her own home, determines the nature of services to be performed, and the manner of performance of such services, is not an employee for Federal employment tax purposes of the parent or parents by whom she is engaged.

Such activity constitutes a "trade or business" the income from which is includible in computing net earnings from self-employment for purposes of the Self-Employment Contribution Act of 1954.

Advice has been requested whether an individual performing child care services in her own home is the employee of the parent or parents engaging her for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954).

In the instant case, an individual takes care of a child whose parents work during the day. The parents leave the child at the individual's home in the mornings before going to work and call for the child in the evenings upon returning from work. The parents rely upon the individual's judgment in caring for the child and issue no instructions other than relative to diet, health and rest and occasionally relative to special foods, medicines, etc., the child may require from time to time. The individual is told whom to contact in case of emergency. She makes her own determinations as to the amount of attention the child requires, the types of meals to be served, and the manner in which she shall cope with any situation likely to arise in rendering child care services. She is free to perform her own household chores at any time during which she feels that the child does not require her personal attention, such as, while the child is taking an afternoon nap. She receives a fixed weekly fee for her services, does not hold herself out to the public as being engaged in such work, and is not licensed for such work.

Section 3121(d) of the Federal Insurance Contributions Act provides that the term "employee" means, among other things, any

individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The guides for determining whether, under such rules, an employer-employee relationship exists are found in section 408.204(c) of Regulations 128, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

Whether an employer and employee relationship exists depends upon the particular facts in each case. Under circumstances similar to those present in this case, where parents leave their child at a person's home each day to be cared for by that individual for a weekly fee, issuing no instructions other than whom to contact in case of emergency, or how and when to give the child medicine in the event of illness, there does not exist, under the usual common law rules, a sufficient right of control on the part of the parents to establish, for Federal employment tax purposes, the relationship of employer and employee between the parents and the individual who cares for the child. Accordingly, the individual is not an employee for such purposes.

Section 1402 of the Self Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954) provides in part:

(a) NET EARNINGS FROM SELF-EMPLOYMENT.—The term "net earnings from self-employment" means the gross income derived by an 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, * * *.

* * * * * * *

(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, * * *.

As a general rule, when a person is engaged in an occupation or profession for profit which constitutes, in whole or in part, his livelihood and, as to such occupation or profession, is not regarded as an employee for purposes of the taxes imposed by the Federal Insurance Contributions Act or otherwise excluded from the self-employment provisions, he is engaged in a "trade or business" within the meaning of section 1402(a), *supra*.

In the instant case it is held that, in caring for a child in her own home under the circumstances set forth above, the individual is engaged in a "trade or business," the income from which is includible in computing net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954. The fact that she is not licensed and cares for only one child is not controlling.

Rev. Rul. 56–71

A company constructing custom-built houses engages agents under written contracts to solicit, negotiate and draw up contracts for the construction of houses. The company furnishes them with leads which they must contact. The agents are required to adhere to company rules and regulations in these contacts and to make daily reports of their activities. They are paid on a commission basis, guaranteed minimum weekly remuneration, and allowed weekly drawing accounts against their commissions. They are permitted to determine their own hours of work, but are required to spend some time as "floor time" on company premises. No license is required of them in this work. *Held*, the agents are employees of the company for Federal employment tax purposes.

Advice has been requested as to the status, under the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954), of individuals engaged by a company to negotiate contracts for the construction of dwelling houses for owners.

The company is engaged in the business of soliciting contracts from the general public for the construction of custom built dwellings in accordance with plans suggested by it or by the person for whom the dwelling is to be constructed. The company engages individuals under a standard form of written agreement to contact interested persons, to negotiate contracts for the construction of dwellings, and to draw up contracts in accordance with procedures stated in the agreement for the construction of the dwellings. The agreement provides, among other things, that the company will furnish the sales agent with the names and addresses of interested owners; that the sales agent will immediately contact all leads furnished to him by the company and in so doing will adhere to all rules and regulations promulgated by the company; that the company will instruct the sales agent in all its specialized methods of operation; and that the company will pay the sales agent as compensation for his services, a certain percentage of the gross contract price on all contracts closed by him.

The services are performed in the company's offices and in the homes of prospective customers. The sales agents are permitted to determine their working hours, except that they are required to spend a prescribed number of hours of "floor time" in one of the company's sales offices. The sales agents are furnished with leads to prospective customers and are required to follow-up and report on such leads. They also are required to adhere to prices, terms and conditions of sale established by the company, and to report in person or by telephone to the main office in addition to turning in daily resumes of their activities. The sales agents are given instructions as to the general technical aspects of home building, calculating costs, and mortgage placement requirements. They are furnished, without charge, the necessary forms to be filled out when calls are made, photographs of homes, floor plans, brochures, and other sales aids of like nature. They operate under the company's name and perform the services on a full-time basis. They are not licensed, are not available to the public to do work of a similar nature, and do not advertise or maintain offices or shops. They are guaranteed a minimum amount of remuneration each week and, in addition, are allowed weekly drawing accounts against anticipated earnings. Each sales agent furnishes and maintains an automobile for use in his work and bears all expenses incurred in his activities on behalf of the company without reimbursement by the company.

Under section 3121(d)(2) of the Internal Revenue Code of 1954, the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The guides for determining whether, under such rules, an employer-employee relationship exists are found in section 408.204(c) of Regulations 128, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

Upon application of the usual common law rules to the factual situation in the instant case, it is concluded that the company has the right to exercise such control over the sales agents in the performance

of their services as is necessary to establish the relationship of employer and employee for Federal employment tax purposes. Accordingly, they are employees of the company for such purposes.

Rev. Rul. 56–87

A summer music camp, which is exempt from Federal income tax under section 501(a) of the Internal Revenue Code of 1954 as an organization of the character described in section 501(c)(3) of the Code, elected to waive its corresponding exemption from tax under the Federal Insurance Contributions Act. In addition to music courses, the camp offers regular courses of instruction in various other arts and employs some of its students on a part-time basis in conducting its activities. *Held*, the camp qualifies as a "school, college, or university" within the meaning of section 3121(b)(10)(B) of the Act and the services performed for the camp by students who are enrolled and are regularly attending classes at the camp are excepted from "employment" by such section.

Advice has been requested relative to the status of a summer music camp for purposes of the taxes imposed by the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954). The camp offers regular courses of instruction in music and various other arts during the summer months. Its educational activities are arranged on a divisional basis and include junior, intermediate, high school and university courses. The university division is operated as the summer session of a state university and credits toward degrees are earned by students enrolled in this division. The camp is exempt from Federal income tax under section 501(a) of the Code as an organization of the character described in section 501(c)(3) thereof and has elected to waive its corresponding exemption from tax under the Federal Insurance Contributions Act provided by section 3121(b)(8)(B) of the Act. Specifically, the camp desires a ruling as to (1) whether it has the status of a "school, college or university" within the meaning of section 3121(b)(10)(B) of the Federal Insurance Contributions Act, and (2) whether the services performed for the camp by its students who are enrolled and regularly attending classes at the camp are excepted from "employment" under section 3121(b)(10)(B) of the Act.

Section 3121(b)(10)(B) of the Federal Insurance Contributions Act provides that services performed in the employ of a school, college, or university are excepted from employment if such services are performed by a student who is enrolled and is regularly attending classes at such school, college, or university. In defining the term "school, college, or university," section 408.219 of Regulations 128, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47, provides that such term is to be given its commonly or generally accepted meaning. Therefore, and on the basis of the facts presented, it is held that the instant camp qualifies as a "school, college, or university" within the meaning of section 3121(b)(10)(B), *supra*.

By reason of its exemption from Federal income tax and the provisions of section 3121(b)(8)(B), *supra*, the camp is not liable for the taxes imposed by the Federal Insurance Contributions Act unless it waives its exemption under section 3121(b)(8)(B). Furthermore, even though exemption under such section is waived by the camp,

liability for such taxes is not incurred with respect to any services performed in its employ which are excepted from "employment" under any other section of the Act. Since the camp qualifies as a "school, college, or university" within the meaning of section 3121 (b) (10) (B) of the Act, services performed for it by its students who are enrolled and are regularly attending classes are excepted from "employment" under such section and the camp is not liable for the taxes imposed by the Act with respect to the remuneration for such services.

Rev. Rul. 56-88

A nonprofit library corporation was organized under a state statute for the purpose of maintaining a free public library, collections in natural history and works of art, and the promotion of intellectual culture generally. Legal title to the buildings, grounds and books is vested in a Board of Trustees, which holds and administers a trust fund created by a will. About two-thirds of the library's finances are derived from the city in which it is located and one-third from endowment funds. Employees of the library are eligible to participate in the city's retirement system. *Held*, the library corporation is not a wholly-owned instrumentality within the meaning of section 3121(b) (7) of the Federal Insurance Contributions Act. *Held further*, a waiver certificate filed pursuant to section 3121(k) of the Act is not terminated as a result of the library's employees becoming eligible to participate in the city's retirement system.

The Internal Revenue Service has been requested to determine whether a library corporation is a wholly-owned instrumentality of a state or its political subdivision within the meaning of section 3121 (b) (7) of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954); also, whether a waiver certificate filed under section 3121(k) of the Act is rendered ineffective because the employees of the library have become eligible to participate in the city's retirement system.

The library was organized as a nonprofit membership corporation under the statutes of a state for the maintenance of a free public library, collections in natural history and works of art, and the promotion of intellectual culture generally. At the outset, it was completely financed by private endowments to a self-perpetuating board of trustees, which still exists. The board holds legal title to the building and grounds, holds and administers the principal of the trust, and pays over the income therefrom to be used by the library corporation under the control and direction of its board of directors. Several years ago the city began making contributions to the library from the general property taxes and at the present time the library is financed two-thirds by the city and one-third by private endowment funds. The tangible personal property, including books, furnishings, and library equipment, is owned outright by the library. The board of directors of the library corporation has charge of all its affairs, elects a librarian, and chooses the librarian's assistants.

Under the state statutes applicable to all public charitable trusts, the library is required to make annual reports of the receipt and use of funds to the state's attorney general. The board of trustees is required to account annually to the county probate court, to the library

corporation, and to the state attorney general. The corporation's charter contemplates perpetual existence. Thus, it is possible that in the event its life should terminate, the *cy pres* doctrine would be applied and a court of equity would appoint a successor trustee to continue the charitable purpose. The library employees have been declared eligible to participate in the city retirement system under a statutory provision which extends such benefits to employees of any free public library to the support of which a city or town contributes not less than half the cost.

Section 3121(b) of the Act contains the following exception from the term "employment," as that term is defined in the Act:

(7) Service * * * performed in the employ of a State, or any political subdivision thereof, or any instrumentality of any one or more of the foregoing which is wholly owned by one or more States or political subdivisions; * * *"

It is held in the instant case that the library is not a wholly-owned instrumentality of the state within the meaning of section 3121(b)(7) of the Act. It was created with private endowments and private funds still constitute a considerable portion of its income. The private corporation maintains full ownership of the building, grounds and books, and its board of directors, rather than the city, has full control of its affairs.

Section 3121(k) of the Act allows a waiver certificate to be filed by an organization exempt from Federal income taxes as an organization of the type described in section 501(c)(3) of the Code where certain conditions are complied with. Section 408.216(b)(3) and (4) of Regulations 128, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47, provides the conditions to be complied with for the termination of the waiver.

The library has been held exempt from the payment of the Federal income taxes as an organization of the type described in section 501(c)(3) of the Internal Revenue Code of 1954. It has filed a waiver certificate under section 3121(k) of the Act and pays taxes under the provisions of the Act with respect to wages paid to its employees. The city objects to the payment of the taxes for the reason that the employees of the library participate in the city retirement system.

The waiver certificate filed by the library under the provisions of section 3121(k) of the Act is not rendered ineffective as a result of the employees' participation in the city's retirement system. Such waiver certificate can be terminated only as provided in section 408.216(b)(3) and (4) of Regulations 128.

Rev. Rul. 56–89

A nonstock library corporation is organized under the charter of the city of *M* and operated pursuant to the General Statutes of North Carolina for the purpose of establishing and maintaining a library and reading rooms for use by the citizens of *N* county. The library is supervised and managed by a library board appointed by the mayor and board of aldermen, and it is operated with funds appropriated mainly by the city, county and state. *Held*, the library corporation is a wholly-owned instrumentality or political subdivision of the State of North Carolina within the meaning of section 3121(b)(7) of the Federal Insurance Contributions Act.

The Internal Revenue Service has been requested to determine the status, for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954), of a nonstock library corporation organized and operated under the circumstances described below.

The corporation was formed for the purpose of establishing and maintaining a circulation library, reading and writing rooms and a reference library, the facilities of which are available to the citizens of the county through a library located in the city of *M*, and through the bookmobile service. The management of the library is under the supervision of a library board composed of six members appointed by the mayor and board of aldermen of the city and approved by the county commissioners. Each member serves for a period of six years, receives no remuneration for his services, and may not succeed himself. The library is organized under the charter of the city. The regulations under which it operates are in conformity with the provisions of the General Statutes of North Carolina relating to public libraries.

Funds for the operation of the library are appropriated mainly by the city and county in which it is located and by the state. A limited amount of income is derived from an investment fund. The librarian, appointed pursuant to the requirements of the North Carolina Library Commission, has sole charge of the administration of the library under the direction and review of the library board. She is responsible for the care of the buildings and equipment, the employment and direction of the staff, the efficiency of service to the public, and the operation of the library under the annual budget. Salaries of all library employees are determined by a classification and pay plan set up by the library board. Annual reports of the operation of the library are submitted to the North Carolina Library Commission, the city of *M*, and the county. The library building is owned by the city. In the event the library operations are discontinued, its funds and other assets would revert to the city and county.

Section 3121(b) of the Act contains the following exception from the term "employment," as that term is defined in the Act:

> (7) Service * * * performed in the employ of a State, or any political subdivision thereof, or any instrumentality of any one or more of the foregoing which is wholly owned by one or more States or political subdivisions; * * *

The determination of whether an organization of the type in question is a state instrumentality is based largely upon the structure of the organization. In the instant case, although the organization is incorporated, it is operated as a public library within the contemplation of the General Statutes of North Carolina, the library board acting as trustees of both city of *M* and the county. Accordingly, it is held that the library corporation is a wholly-owned instrumentality or political subdivision of the State of North Carolina within the meaning of section 3121 (b) (7) of the Federal Insurance Contributions Act. Services performed in its employ are excepted from employment under the provisions of that section.

Rev. Rul. 56–109

Services performed by an employee as a companion to a convalescent employer or any member of his household, which services consist of entertaining, caring for the personal needs of, living in the home of, accompanying the convalescent on trips, and any other services necessary for the comfort or well-being of the convalescent, constitute "domestic service in a private home of the employer" within the meaning of section 3121(a)(7)(B) of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954).

(Also Section 3401.) Rev. Rul. 56–118

Farm employers, including organizations exempt from income tax under section 501(a) of the Internal Revenue Code of 1954, who pay "wages" for both "agricultural labor" as defined in the Federal Insurance Contributions Act and for nonagricultural services must (1) segregate the "wages" for "agricultural labor" from other "wages" paid; (2) file Form 943 reporting the Federal Insurance Contributions Act taxes due with respect to "wages" paid to employees for "agricultural labor;" and (3) file Form 941 reporting the Federal Insurance Contributions Act taxes on, and the income tax withheld from, "wages" paid to employees for other "employment."

Advice has been requested, for purposes of the Federal Insurance Contributions Act and the Collection of Income Tax at Source on Wages (chapters 21 and 24, respectively, subtitle C, Internal Revenue Code of 1954), (1) as to the procedure to be followed by farm employers, including organizations exempt from income tax under section 501(a) of the Code, in reporting "wages" paid after 1954 to individuals who perform both agricultural and nonagricultural services, and (2) whether such organizations should apply the "$50 earned in a quarter" test or the "$100-a-year" test in the cases of such workers.

Some employers employ individuals to perform both agricultural and nonagricultural services. In some pay periods of the year, most of the time of an employee is spent in one activity. In other pay periods, most of the employee's time is spent in the other activity.

The term "employment" as defined in section 3121(b) of the Federal Insurance Contributions Act in force on and after January 1, 1955, contains no specific exception for services which constitute "agricultural labor" other than those provided in section 3121(b)(1) relating to services in connection with certain gum resin products and services performed by certain foreign agricultural workers. Accordingly, "agricultural labor" as defined in section 3121(g) of the Act generally constitutes "employment" except to the extent otherwise provided in section 3121(b)(1), *supra*.

Service performed in any calendar quarter in the employ of any organization exempt from income tax under section 501(a) of the Internal Revenue Code of 1954 (other than an organization described in section 401(a)), or under section 521 of the Code, is excepted from "employment" under section 3121(b)(10)(A) of the Federal Insurance Contributions Act if the remuneration for such service is less

than $50. This "$50 earned in a quarter" test has no application with respect to any such organization of the character described in section 501(c)(3) of the Code which has not waived the exemption granted under section 3121(b)(8)(B) of the Act.

The rules relating to included and excluded services contained in section 3121(c) of the Act are not applicable unless during a pay period an employee performs services which constitute "employment" (including "agricultural labor") and services which are excepted from "employment" under a specific provision of section 3121(b).

Under the provisions of section 3121(a)(8)(B) of the Act, the term "wages" does not include cash remuneration paid in any calendar year by an employer to an employee for "agricultural labor" which constitutes "employment" if the cash remuneration paid in such year by the employer to the employee for such labor is less than $100. This is sometimes referred to as the "$100-a-year" test. If an employee receives cash remuneration from an employer both for "agricultural labor" which constitutes "employment" and for other services, only the amount of such remuneration which is attributable to such "agricultural labor" should be included in determining whether the "$100-a-year" test is met.

As to an exempt organization's application of the tests, that is, the exception from "employment" (the "$50 earned in a quarter" test), and/or the exclusion from "wages" (the "$100-a-year" test), it will be noted that since such tests relate to two different factors, namely, "employment" and "wages," consideration of both may be necessary in some cases. Thus, if the remuneration earned in a calendar quarter by an employee of such an organization amounted to $50 or more, the services of the employee would not be excepted from "employment" under section 3121(b)(10)(A), *supra*, and if no other exception is applicable such services would constitute "employment." If the services of such employee were "agricultural labor," it would be necessary to ascertain whether his remuneration constituted "wages," that is, whether he received $100 or more in cash in a calendar year for such "agricultural labor." On the other hand, if the employee's remuneration earned in a calendar quarter did not amount to $50, his services in that quarter would not constitute "employment" (even though such services constitute "agricultural labor") and such remuneration, whenever paid, would not be considered in applying the "$100-a-year" wage test.

Such an organization stands in the same category as any other employer. Consequently, if the organization pays "wages" for "employment" (including "agricultural labor"), it will be required to conform to the procedures set forth below regarding a separate reporting of its agricultural and nonagricultural employees.

Section 8 of the 1956 revision of Circular A, Agricultural Employer's Social Security Tax Guide, should be followed by employers in filing returns with respect to agricultural employees. Section 10 of such Circular should be followed in making deposits of Federal Insurance Contributions Act taxes with respect to "wages" for "agricultural labor." The revised Circular A, which is available at district directors' offices, includes two important changes in procedure effective January 1, 1956, as follows:

(a) If the total of the employee tax deducted and the employer tax with respect to "wages" paid for "agricultural labor" exceeds $100 at the end of any month or period of two or more months (other than December), a deposit must be made on or before the fifteenth day of the following month. Thus, no deposit is required for December taxes or for a period ending December 31, even though the total of the taxes in either case, exceeds $100.

(b) Form 943A (the quarterly return used in 1955 to report taxes of $100 or more) will no longer be used. Each employer of agricultural employees will continue to file an annual return on Form 943, Employer's Annual Tax Return for Agricultural Employees.

"Wages" for services other than "agricultural labor" are not to be reported on Form 943. Such wages are to be reported on Form 941, Employer's Quarterly Federal Tax Return (or, if paid for household services not performed on a farm operated for profit, they may be reported on Form 942, Employer's Quarterly Federal Tax Return for Household Employees).

Accordingly, if only part of an employee's services constitute "agricultural labor," or if some of an employer's workers perform services which constitute "agricultural labor" and other employees do not, it is necessary for the employer (1) to segregate the "wages" for "agricultural labor" from the other "wages" paid; (2) to file Form 943 reporting the Federal Insurance Contributions Act taxes due with respect to the "wages" for "agricultural labor;" and (3) to file Form 941 reporting the Federal Insurance Contributions Act taxes due with respect to the "wages" for other "employment."

Income tax withheld from an employee's "wages" is to be reported on Form 941. However, remuneration paid for "agricultural labor," as defined in the Federal Insurance Contributions Act, is excluded from "wages," as defined in section 3401(a) of the Code of 1954, for purposes of the income tax withholding under section 3402 of the Code. For the application of the rules relating to "included and excluded wages" in determining whether all, or none, of an employee's remuneration for a pay period shall be deemed to be "wages" subject to the income tax withholding, see Revenue Ruling 55–707, C. B. 1955–2, 420, at 422.

Rev. Rul. 56–119

The owner of a motel engaged a man and his wife as managers thereof at a specified rate per week. They are required to furnish service twenty-four hours daily, register guests, collect rents and maintain the rooms in good condition. The owner provides all furnishings, equipment and office supplies. *Held*, the managers are employees of the owner for Federal employment tax purposes.

Advice has been requested relative to the status, for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954), of two people engaged by a corporation to manage a motel which it owns.

Pursuant to an oral agreement with the corporation, a man and his wife agreed to manage the motel for a specified amount per week. The corporation does not specify the amount each individual may receive or prescribe the specific duties each is to perform. Under the terms of the agreement, a twenty-four hour daily duty is required which may be divided as the couple desires. The managers receive and register guests for rooms, collect rent, maintain rooms in a clean and livable con-

dition, make minor repairs, and perform all other services necessary for the comfort of guests. The corporation provides all furnishings, equipment and office supplies. No part of the operating cost is sustained by the managing couple. Major maintenance and repair work may be performed only on authorization by the owner.

The corporation establishes guest service charges and operating policies. Three or four times a week an officer of the corporation inspects the premises to assure its proper care and operation and to collect the rent received by the managers. The owner frequently gives instructions which it considers will improve operating conditions.

Section 3121(d) of the Act provides that the term "employee" means, among other things, any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The guides for determining whether, under such rules, an employer-employee relationship exists are found in section 408.204(c) of Regulations 128, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

While in the instant case considerable latitude is given the managers in the allocation of duties, it is apparent that the corporation has not relinquished its right, as owner, to require the managers to comply with any instructions it may care to give in the over-all performance of their management services. It is held that the corporation exercises or retains the right to exercise the direction and control, over the services performed by the managers, necessary to establish an employer-employee relationship for Federal employment tax purposes. Accordingly, the managers are employees of the corporation for such purposes.

(Also Section 3401.) Rev. Rul. 56–129

"Dealers" engaged by a company to distribute its bakery products under contracts whereby they agree to furnish their own trucks are held, under the facts and upon application of the usual common law rules, to be employees of the company for Federal employment tax purposes.

Where the method used by the company in determining the "dealers'" wages fails to reflect the correct amount of wages earned by its "dealers" for purposes of the Federal employment taxes, including the income tax withholding, the company should adopt a method of computing wages similar to that stated in Mimeograph 6787, C. B. 1952–1, 192.

The Internal Revenue Service has been requested to determine the status, for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act taxes and Collection of Income Tax at Source on Wages (chapters 21, 33, and 24, respectively, subtitle C, Internal Revenue Code of 1954), of individuals performing services as "dealers" in the distribution of bakery goods for a company under the circumstances described below. Also, in the event such "dealers" are held to be its employees, advice has been requested relative to the method to be used in computing the wages paid to such individuals for purposes of the above taxes.

The company is engaged in manufacturing bakery products which are distributed through so-called "dealers." The "dealers" devote their full time to distributing the company's products and receive as

remuneration for their services the difference between the prices they pay the company and the prices they charge customers for the products. Under the terms of the contracts entered into between the "dealers" and the company, the company agrees to sell to the "dealers" and the "dealers" agree to purchase from the company bakery goods and wares for resale within such territory as may be agreed to from time to time between the parties. The "dealers" agree to furnish suitable vehicles to be used in selling the goods; to procure and pay for adequate insurance in order to protect the company from any liability for use of the vehicles; and to refrain, upon the termination of the agreement, for a period of one year, from selling bakery goods for others in the territory where they sold company goods. The contract is not assignable by the "dealer" without the company's consent, but it may be terminated by either party at any time upon proper notice.

The "dealers" apply to a sales manager for assignments of routes. They are given certain training in the work by a route supervisor, who also renders assistance to the "dealers" at company expense, counsels with them whenever he deems it necessary for the good of the business, and is responsible for collecting amounts due the company. Weekly and monthly customers are billed on the company's billheads and remittances in most cases are made direct to the company and credited to the "dealers' " accounts, while daily accounts are collected by the "dealers." The company advises the "dealers" of telephone orders received and of new customers transferring into their territories, and they serve these and other customers designated by the company, as well as those obtained through their own efforts. The company furnishes route sheets, cards, baskets, and lists without charge to the "dealers." In addition to furnishing their own trucks which bear the company's name, the dealers pay all expenses incurred in distributing the company's products and do not account to the company for such expenses. The "dealers" are included in the company's group insurance plan and deferred profit-sharing plan. They do not hold themselves out to the public as available to do work of a similar nature for others and they do not perform services for others.

The company has, in the past, regarded its "dealers" as employees and has computed their "wages," for purposes of both the Federal Insurance Contributions Act and the income tax withholding, on the basis of a selling price markup of thirty percent of cost less an estimated total selling expense of fourteen percent, resulting in an amount reported as "wages" of sixteen percent of the individuals' gross sales. However, an audit of the "dealers" income tax returns showed that their estimated "wage" figures average about twenty percent below the actual profit realized from operation of the routes, and thus the employee tax and the employer tax under the Federal Insurance Contributions Act and the income tax required to be withheld are not being collected on the twenty percent differential, and the individual's wage credits are understated by the same twenty percent.

Section 3121(d)(2) of the Federal Insurance Contributions Act defines an employee as any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The rules for determining whether, under the usual common law rules, an employer-employee relationship exists are found in section 408.204(c) of Regulations 128,

applicable to the provisions of the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

Although the dealers are required to furnish their own trucks in rendering their services for the company, their investments are only one of the factors to be considered in determining whether they are subject to the direction and control prescribed by the applicable regulations. It is entirely possible for an individual who has invested in a truck to use his vehicle while engaged in the employment of another. Thus, the presence of an investment factor, in and of itself, does not warrant classification of the "dealers" as independent contractors. Also, while the relationship of employer and employee usually implies the payment by the employer of "wages" for services rendered, and in the instant case the amounts received by the "dealers" are not actually paid by the company, the arrangement is such that payment may properly be ascribed to the company. The amounts received by the "dealers," representing the difference between the wholesale and retail prices, less authorized deductions, constitute their compensation. The effect of the contract involved is substantially the same as if the "dealers" turned over to the company all of the retail price collected by them, less cost of gasoline and other authorized expenses, and the company returned to the "dealers," as their compensation, the sum remaining after deducting the wholesale price of the products.

In view of all of the facts present in this case, it is held that the company exercises or has the right to exercise such control over its "dealers" in the performance of their services as is necessary under the usual common law rules to establish the relationship of employer and employee. Accordingly, liability for the Federal employment taxes, including the income tax withholding under section 3402 of the Code, is incurred by the company with respect to "wages" of the dealers.

Since all of the remuneration of the "dealers" does not fall under the control of the company so as to be actually paid by the company, a method of computing the wages of the "dealers" similar to that stated in Mimeograph 6787, C. B., 1952–1, 192, should be adopted, notwithstanding the fact that the "dealers" are employees under the usual common law rules rather than under the statutory definition contained in section 3121(d)(3)(A) of the Federal Insurance Contributions Act.

Rev. Rul. 56–130

Under the terms of one contract, an individual performs services as a writer and idea man for a television network. He is given much leeway as to his hours of work and type of writing, but is required to produce such material as the network may request, to collaborate and confer with other persons, and to meet deadlines set by the network. He is paid a stated sum each week and royalties. Under the terms of another contract of the same date, he is employed to perform services subject to the direction and control of the network as a writer, producer, or director for a stated sum each week. His services are exclusive to the network for a definite period. *Held*, the individual is an employee of the network, for Federal employment tax purposes, with respect to services performed under both contracts.

Advice has been requested as to the status, under the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954), of an individual performing services as a writer and idea man pursuant to a "Program Idea Agreement" and an "Employment Agreement" with a television network.

Under the terms of the "Program Idea Agreement," the writer agrees that he will furnish his artistic and professional services in the creation, writing and development (alone or in collaboration with such other persons as he and the network may determine) of titles, ideas, methods, stories, characters, characterizations, locales, incidents, formats, plots, formulas, names and themes, and treatments of any of the foregoing, for both commercially sponsored and sustaining television programs, as the network may request; that during such periods as he is not performing services pursuant to the specific requests of the network he will devote his time to the creation and development of such new program ideas and formats as he may consider suitable for network broadcasting; that he will confer with such persons as the network may from time to time designate, with certain limitations on out-of-town conferences; and that he will meet any deadline imposed by the network with respect to the delivery of materials which it requests. For all services to be performed under the agreement and all rights granted therein, the network agrees that it will pay the individual a stated sum each week, and royalty payments based on the use of materials created by him; also, that if it sends him to a certain city it will pay his transportation expenses and reimburse him for other expenses. The agreement also provides that the network will have the right to require him to perform services as a producer, director, or writer on such commercially sponsored programs as the network may elect, such services to be performed pursuant to agreements negotiated between the writer and the network.

The "Employment Agreement" provides, among other things, that the network employs the writer and the writer agrees to perform artistic and professional services as required by the network, as a writer, producer, or director, for a stated sum each week; that he will attend such program conferences as are scheduled by the network; that he will not perform similar services for others; and that his services will be performed subject to the direction and control of the network.

It has been established that the individual's services for the network are performed in accordance with the terms of the above-mentioned agreements. Neither of such agreements may be terminated prior to the effective termination date of the other.

Under section 3121(d)(2) of the Internal Revenue Code of 1954, the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The guides for determining whether, under such rules, an employer-employee relationship exists are found in section 408.204(c) of Regulations 128, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C.B. 1954–2, 47.

Upon the application of the usual common law rules to the factual situation in the instant case, it is concluded that the television network exercises or has the right to exercise such control over the individual in

the performance of his services as is necessary to establish the relationship of employer and employee. The nature of the services performed under the "Program Idea Agreement" is such as to make close supervision impracticable, but the information shows that, under both arrangements, the individual is required to perform the services personally, that he is at all times subject to call by the network, that he is required to confer with persons in regard to the work at places designated by the network, and that his services are completely exclusive to the network during the time the agreements are in effect. Accordingly, it is held that under each agreement the individual is an employee of the network for Federal employment tax purposes.

Rev. Rul. 56–131

An individual is engaged by a golf association to supervise the work of volunteer handicappers of its member clubs and to assign to each club member desiring a rating an association handicap based on the player's best score over a period of time. The handicap secretary is required to comply with the methods and rules prescribed by the association in its handicapper's manual. She receives a fixed amount of remuneration payable monthly. *Held*, the handicap secretary is an employee of the association for Federal employment tax purposes.

Advice has been requested as to the status, under the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954), of an individual who performs services for a golf association as a handicap secretary.

The golf association is a voluntary association of private golf clubs. The association has no constitution but its by-laws and standing rules show that its objects are to promote the interests of golf among women and to conduct an annual championship tournament and such other tournaments and activities as will further the best interests of golf; that one of the officers is a handicap chairman who has charge of the handicaps and the handicap system and that a secretary for the handicap chairman may be engaged if approved by the board of directors.

In order to insure uniformity of handicaps, the association has set forth in a manual a standardized handicapping system, based on the general rules laid down by the United States Golf Association, and has engaged a handicap secretary to supervise the work of the volunteer handicappers of each member club and to assign to each club member desiring a rating an association handicap based on the player's best score over a period of time. The handicap secretary performs her services under an oral agreement. The association prescribes in the handicapper's manual, the general methods and rules by which handicaps are to be ascertained and the handicap secretary is required to comply with such methods and rules. In performing the services, the handicap secretary receives regular reports from the volunteer handicappers of each club. These reports are checked and, if necessary, corrected. Association handicaps are then periodically assigned to the respective players on the basis of these reports. An appeal from a determination of the handicap secretary may be made to the association officer serving as the handicap chairman. He may change the determination in accordance with any rulings issued by the board of directors.

The handicap secretary maintains various ledgers and files, conducts constant correspondence with the various club handicappers and individual members, and holds an annual meeting of club handicappers for the purpose of discussing handicap principles. The handicap secretary does all the work in her home. The desk, file cabinets, typewriter and other equipment used by her are her own personal property. Supplies are furnished by the association. The handicap secretary performs her services during such hours as are convenient to her and she is at liberty to do similar work for others. However, the records and data pertaining to the association's handicaps, handicapping rules and practices are confidential and she may not use them when performing services for others. Her remuneration is a fixed amount, payable monthly.

Under section 3121(d)(2) of the Internal Revenue Code of 1954, the term "employee" includes any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The guides for determining whether, under such rules, an employer-employee relationship exists are found in section 408.204(c) of Regulations 128, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

Upon application of the usual common law rules to the factual situation in the instant case, it is concluded that the golf association exercises or has the right to exercise such control over the handicap secretary in the performance of her services as is necessary to establish the relationship of employer and employee for Federal employment tax purposes. Accordingly, the secretary is an employee of the association for such purposes.

(Also Section 1402.) Rev. Rul. 56–132

An individual who performs geological engineering and special geological research for clients on a part time basis, holds his services available to the general public, is remunerated for his services on a fee basis, performs the services, other than field work, in his home, and determines the means and methods of operation, is not an employee of such clients for Federal employment tax purposes.

Income derived in any taxable year ending after 1954 from such services should be considered in computing net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954.

The Internal Revenue Service has been requested to determine the status, for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954) and the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, of the Code), of an individual who performs geological engineering and special geological research under the circumstances described below.

The individual is engaged in full-time employment as a geological engineer. In addition, he holds himself out to clients to undertake on a fee basis, specific assignment in geological engineering work and special geological research during evenings and weekends. He determines the fee to be charged for his work and submits preliminary estimates to his clients before the work is awarded to him. The fee charged is based on the size of the area, the type of work to be accom-

plished and the method of presentation, as where only a report is required or a report plus annotated maps and/or aerial photographs are required. Additional charges may be made if the job requires considerable detailed study, investigation and field work. The time required depends on each job performed and varies from a few days to a week or possibly a month. The requirements of the research assignments are set forth by the clients, but no other instructions or orders are issued to him. The clients also furnish the necessary maps, aerial photographs and such published materials as are needed in connection with the assignment. The means and methods of carrying out the assignment, as well as the hours during which he performs the services, are left to the judgment of the individual. He performs his services in his own home and when a job is completed he submits his report, returns all maps and materials used in conjunction therewith, and issues an invoice for his services.

Under section 3121(d)(2) of the Federal Insurance Contributions Act, the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The rules for determining whether, under the usual common law rules, an employer-employee relationship exists are found in section 408.204(c) of Regulations 128, applicable to the provisions of the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

Whether an individual is an independent contractor or an employee is largely a question to be determined upon consideration of the particular facts in each case. In the instant case, it is concluded that the individual is not an employee, for purposes of the Federal Insurance Contributions Act, of the clients for whom the services are performed, but is an independent contractor with respect to such services. This conclusion is based principally upon the fact that the clients for whom the services are performed have the right to control and direct the individual only as to the results to be accomplished by the work and not as to the details and means by which such results are accomplished.

Section 1402(c) of the Self-Employment Contributions Act of 1954 provides that 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 of the 1954 Code (relating to trade or business expenses), with certain exceptions not here material.

Generally, an individual who is not an employee, for Federal employment tax purposes or otherwise excluded from the self-employment tax provisions, and who is regularly engaged in an occupation or profession for profit which constitutes all or a part of his livelihood, is engaged in a "trade or business" within the meaning of section 1402(c), *supra*.

It is held that an individual performing services described herein under the circumstances stated is engaged in a "trade or business" with respect to such services and the income he derives therefrom in any taxable year ending after 1954 is includible in computing net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954.

Rev. Rul. 56–154

A regular member of the police force of the city of *M* who, during his off-duty hours, is engaged and paid by a merchant to regulate lines of customers outside the merchant's business establishment so that entrances of nearby business establishments are not blocked, is an employee of the merchant for purposes of the Federal em ployment taxes.

Advice has been requested as to the status, for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954), of a public police officer who performs services during his off-duty hours for a merchant.

The merchant, a cafeteria operator in the city of *M*, found it necessary to engage an individual for the purpose of keeping lines of patrons which form outside the cafeteria from interfering with entrances and exits of adjacent places of business. For this purpose the merchant engaged a regular city police officer, recommended by the police department, who performs similar services for others during his off-duty hours from regular police work. Such "off-duty" work is obtained by the policeman through his own initiative and not as the result of official assignments by the police department. While on this work, the police officer does not wear a uniform and is not identified as being a member of the police department. The merchant entered into an agreement with the police officer to regulate the waiting lines in front of the merchant's place of business. He designates the time the police officer is to be on duty, instructs him as to what is to be done, determines and pays his wages, and may terminate his services at any time.

A police officer of the city of *M* is required to take an oath to uphold the laws twenty-four hours per day, if necessary, and is subject to call twenty-four hours per day. If an emergency arises the police department may direct the police officer to serve in the emergency.

Under section 3121(d)(2) of the Federal Insurance Contributions Act, the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The guides for determining, under such rules, whether an employer-employee relationship exists are found in section 408.204(c) of Regulations 128, applicable to the provisions of the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

Whether an employer-employee relationship exists depends on the particular facts in each case. In the instant case the merchant has the right to and does direct and control the police officer in the performance of the services rendered pursuant to the agreement. The facts that the officer is recommended by the police department and is subject to call to public duty in case of an emergency do not affect the relationship existing between the merchant and the officer.

Accordingly, upon application of the usual common law rules, it is held that with respect to the services performed for the merchant the police officer is an employee of the merchant for Federal employment tax purposes.

See S. S. T. 327, C. B. 1938–2, 317, and Rev. Rul. 54–616, C. B. 1954–2, 346.

Rev. Rul. 56–155

An experienced floor layer, who provided his own tools, entered into an oral agreement with a corporation to perform full time services at construction sites. The corporation furnished all materials, made frequent inspections of the work and carried workmen's compensation insurance on the worker. *Held*, the floor layer is an employee of the corporation for Federal employment tax purposes.

Advice has been requested relative to the Federal employment tax status of an experienced floor layer, who furnished his own tools, with respect to the services he performed for a corporation engaged in a floor laying and finishing business.

Pursuant to an oral agreement entered into with the corporation, for an indefinite period, an individual, experienced in his particular trade and who furnished his own tools, laid floors on a full time and piecework basis. All work was performed in the name of the corporation. It furnished all materials, made frequent inspections of the work performed, occasionally issued instructions regarding the performance of particular work, and carried workmen's compensation insurance on the worker. The work was performed at construction sites, in the order designated by the corporation, and in accordance with the specifications. The worker followed the regular routine established by the corporation and several times a week reported the progress made in his work. The worker's services could be terminated at any time by either party. The worker did not maintain his own place of business, advertise his services, maintain a business listing in the telephone directory, or otherwise hold himself out as available to perform similar services for others.

Section 3121(d) of the Federal Insurance Contributions Act provides, among other things, that the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The rules for determining whether, under the usual common law rules, an employer-employee relationship exists are found in section 408.204(c) of Regulations 128, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

From the facts presented, it is held that the corporation exercises or retains the right to exercise the direction and control over the services performed by the floor layer necessary to establish an employer-employee relationship for Federal employment tax purposes. Accordingly, the worker in this case is an employee of the corporation for such purposes.

Rev. Rul. 56–156

An individual performs services as a contest manager for an organization which furnishes puzzle contests to newspaper publishers for circulation promotion purposes. The organization employs him on a continuing basis, assigns him to the various newspapers with which it has promotion campaign agreements, and requires him to keep records and furnish daily reports. He performs his services on the publishers' premises, regulates his own working time, may perform services for others, furnishes no supplies or equipment, is paid a weekly salary or commission, and is reimbursed for his expenses. *Held*, he is an employee of the organization for Federal employment tax purposes.

An inquiry has been received relative to the status, for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954), of an individual performing services for an organization as a puzzle contest manager under the circumstances described below.

The organization is engaged in furnishing newspaper publishers in various cities with puzzle contests used by the publishers for circulation promotion purposes. In accordance with an agreement entered into between the parties, the organization furnishes the publisher with advertising copy, suggestions for circulars, rack card copy, radio announcements and publicity stories relating to its puzzle contests. Such material may be used at the option of the publisher and, together with the official contest rules, is subject to revision by the publisher. The organization also agrees to furnish, at its expense, an experienced manager to perform services during the entire promotion period. The publisher agrees to provide, at his expense, prize money, newspaper cuts, printed matter, and postage, and to pay the clerical, mailing and incidental expenses. The publisher also agrees to pay the organization a specified amount, on a sliding scale, on all bona fide complete sets of puzzle solutions received during the promotion period as well as specified amounts for new subscriptions to the newspaper.

The individual in question is engaged by the organization to perform contest managerial services and is assigned by the organization to various newspapers with which it has promotion campaign agreements. His specific duties are to exercise general supervision over the details of the campaign by checking all copy, layouts, and puzzles, and seeing that contestants adhere to the puzzle rules; to record the number of entries and subscriptions received and to furnish this information daily to the circulation manager of the paper and to the organization; to see that subscriptions are properly entered and credited; and to do everything possible to promote good public relations with the press and the public. He is not required to perform sales services. If stenographic, clerical, or other help is needed, it is hired and paid by the newspaper. The manager's services are performed on the premises of the publisher during regular working hours, although he is not required by the organization to keep regular working hours or to spend a specified portion of his time in its interests. On some assignments he is paid a weekly salary, and on others he is paid a commission basis. He is reimbursed by the organization for all expenses incurred in the performance of his services; may draw advances against anticipated earnings; is eligible for a bonus in the event of a successful contract, and is remunerated during periods of sickness. He may perform similar services for others. The organization and he may terminate his services at any time and for any good reason.

Section 3121(d) of the Federal Insurance Contributions Act provides, among other things, that the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. Whether an individual is an independent contractor or an employee is largely a question to be determined upon the particular facts in each case. The guides for determining, under the usual common law rules, whether an employer-employee relationship

exists, are found in section 408.204(c) of Regulations 128, applicable to the provisions of the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47.

It is clearly shown, by the facts presented above, that the individual in question is engaged by the organization to render personal services on a continuing basis in managing its puzzle contests. The organization assigns him to his various posts of duty and his services are performed as an essential part of its operation, since it is the organization's contractual obligation to furnish managerial services to publishers. Further, his presence is required to insure protection of the organization's interests with respect to proper recording of, and payment for, puzzle entries and subscriptions. The organization has, and exercises, the right to fix the general nature of the work to be done and the general methods to be followed in accomplishing the desired results, even though it may not be possible for it to physically supervise him in the actual performance of his services. The facts that the individual may perform similar services for others and the organization does not require him to maintain regular working hours are not controlling. Accordingly, it is held that, for Federal employment tax purposes, including the withholding of income tax at source on wages, the relationship between the organization and the individual is that of employer and employee.

Rev. Rul. 56–173

The *M* county hospital established and operated pursuant to the provisions of chapter 131 of the General Statutes of North Carolina through a board of trustees appointed by the board of county commissioners is a wholly owned instrumentality of *M* county, a political subdivision of the State of North Carolina. Services performed in its employ are excepted from "employment" under sections 3121(b)(7) and 3306(c)(7) of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, respectively. However, the hospital is responsible for withholding income tax from the wages paid its employees.

Advice has been requested relative to the status of the *M* county hospital for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax At Source on Wages (chapters 21, 23, and 24, respectively, subtitle C, Internal Revenue Code of 1954).

The *M* county hospital is an unincorporated, nonstock, and nonprofit institution established and operated pursuant to the provisions of chapter 131 of the General Statutes of North Carolina through a board of trustees appointed by the board of county commissioners. It was constructed and equipped as a county project under the Hill-Burton Act, 60 Stat. 1040, 42 U. S. C. 291, with funds contributed by the Federal, State and county governments. All vacancies in the membership of the board of trustees are filled by the board of county commissioners. The board of county commissioners may, after notice and hearing, remove any member of the board of trustees for gross inefficiency, neglect of duty, immoral conduct, or conviction of any felony or other crime involving moral turpitude.

Title to all property used in the operation of the hospital is vested in *M* county. A resolution adopted by the board of county commis-

sioners creating the board of trustees prescribes the qualifications and terms of office of the members. The resolution provides that the board of trustees shall organize as the operating body of the hospital and shall make and adopt such bylaws, rules, and regulations for the hospital as may be deemed expedient for its conduct and operation. The hospital is to be operated at all times and in every respect administered as a charitable, nonprofit hospital. All books, records, papers, invoices, accounts, and documents of the hospital must be open to inspection by the board of county commissioners or its duly authorized agent. No trustee may receive any compensation for his services but may receive reimbursement for any cash expenditures actually made for personal expenses incurred as such trustee.

The trustees are empowered to appoint all necessary employees, fix their compensation, and discharge them. The trustees are required to establish, by regulations, a reasonable but adequate and uniform scale of fees and charges for the use of the facilities and services of the hospital. Any profits derived from the operation of the hospital are to be used exclusively for charitable purposes and the objectives of the hospital, including the expansion of facilities and the purchase of supplies for charity patients.

The activities of the hospital are financed from fees received from patients, appropriations by the board of county commissioners, income from an endowment fund, gifts, and a tax against all property in the county authorized by vote of the people of the county. An annual audit is made by a certified public accountant selected by the board of county commissioners and copies of such audit are submitted to the commissioners and the trustees.

Section 3121(b) of the Federal Insurance Contributions Act excepts from the term "employment," as that term is defined in the Act:

> (7) Service * * * performed in the employ of a State, or any political subdivision thereof, or any instrumentality of any one or more of the foregoing which is wholly owned by one or more States or political subdivisions; * * *

Section 3306(c)(7) of the Federal Unemployment Tax Act contains a similar provision.

It is concluded that the *M* county hospital is a wholly owned instrumentality of *M* county, a political subdivision of the State of North Carolina. Services performed in its employ are excepted from "employment" by sections 3121(b)(7) and 3306(c)(7) of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, respectively, and the taxes imposed by the Acts are not applicable to the remuneration for such services. However, the hospital is responsible for withholding income tax from the wages paid its employees.

See Rev. Rul. 55–319, C. B. 1955–1, 119, relative to coverage of State employees under the Social Security Act.

Rev. Rul. 56–174

A "county" hospital which is not established and operated pursuant to the statutes of the State of North Carolina relating to public hospitals is not a wholly owned instrumentality or political subdivision of that State for Federal employment tax purposes.

Advice has been requested whether a "county" hospital organized and operated in the manner described below constitutes a wholly owned instrumentality of a state or a political subdivision thereof for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954).

The *N* county memorial hospital was incorporated under the laws of the State of North Carolina as a nonstock, nonprofit corporation organized to establish, build, maintain, manage, and operate a hospital for the general welfare of the citizens of *N* county. The hospital is not established and operated pursuant to the provisions of chapter 131 of the General Statutes of North Carolina relating to hospitals which are instruments of cities, counties, the state, or public hospital authorities, except that under such statutes a license to operate must be obtained by all hospitals in the state from the North Carolina Medical Care Commission. The site of the hospital was purchased with funds voluntarily constributed by individuals in the community and title is vested in the corporation. The buildings were constructed and equipment was provided under a program administered by the North Carolina Medical Care Commission and their cost was financed with a Federal grant under the Hill-Burton Act, 60 Stat. 1040, 42 U. S. C. 291, an appropriation by the North Carolina Legislature, and private subscriptions.

Membership in the corporation is open to any adult citizen of the United States. A citizen desiring membership must have his name put in nomination by a member in good standing, and two-thirds of the membership must vote for his admission. Membership may be terminated by resignation or suspension by vote of the membership.

The corporation's by-laws provide for the election, by and from the membership, of a board of trustees consisting of eighteen members. There are no requirements that the state, county, or municipal government be represented on the board of trustees. At the annual meeting the trustees elect the officers and appoint various committees to serve until the following annual meeting.

The executive committee has charge of the general management of the hospital and the maintenance of its property. It makes rules for the government of the hospital, the admission and discharge of patients, and the conduct of patients and employees. The finance committee devises ways and means of securing funds for the support of the hospital. This committee authorizes investments and disbursements by the treasurer; prepares a budget, including a salary schedule for all employees; and attends to all financial interests of the corporation. The committees act under the direction of the trustees at all times and report their actions to them at such times as they may direct. The duties of the officers are set forth in the corporation's by-laws. The *N* county commissioners have no control, or right of control, over the hospital's personnel or its policies.

Section 3121(b) of the Act contains the following exception from the term "employment," as that term is defined in the Act:

> "(7) Service * * * performed in the employ of a State, or any political subdivision thereof, or any instrumentality of any one or more of the foregoing which is wholly owned by one or more States or political subdivisions; * * *"

The determination of whether an organization of the type in question is a state instrumentality is based largely upon the structure of the organization. In the instant case, although the hospital operates under a name indicative of a "county" hospital, it is a private corporation, and, as stated above, is not established and operated pursuant to that chapter of the state statutes applicable to hospitals which are, in fact, instruments of cities, counties, or the state.

Based on the foregoing, it is concluded that the hospital does not qualify as a wholly-owned instrumentality of the State of North Carolina or a political subdivision thereof for Federal employment tax purposes.

See Rev. Rul. 55–473, C. B. 1955–2, 425, regarding social security coverage of individuals employed by certain tax-exempt organizations.

(Also Section 1402.) Rev. Rul. 56–187

Services performed by a duly ordained, commissioned, or licensed minister of a church in an executive or administrative capacity for the *X* Federation of Churches are in the exercise of his ministry and are excepted from "employment" under section 3121(b)(8)(A) of the Federal Insurance Contributions Act.

The Internal Revenue Service has been requested to determine whether services performed by a duly ordained, commissioned, or licensed minister of a church in an executive or administrative capacity for the *X* federation of churches are in the exercise of his ministry and excepted from "employment" under the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954).

The *X* federation of churches was organized by some of the local congregations of the city in order that they might work together toward meeting the religious and moral needs of the community. It is an official interdenominational agency serving the member denominations and is under the supervision of a governing body of delegated representatives appointed by the member denominations.

The federation has been granted exemption from Federal income tax as a religious organization of the character described in section 501(c)(3) of the Internal Revenue Code of 1954. However, exemption under the Federal Insurance Contributions Act has been waived in order to provide coverage for its employees under Title II of the Social Security Act.

Section 3121(b)(8)(A) of the Internal Revenue Code of 1954 provides, in part, for the exception from "employment" of service performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry. Section 408.215 of Regulations 128, applicable to the provisions of the Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47, provides that the duties of ministers include the control, conduct, and maintenance of religious organizations under the authority of a religious body constituting a church or church denomination.

Although the *X* federation of churches is not under the authority of a religious body constituting a *particular* church or church denomination, it is composed of churches having fundamentally similar ob-

jectives and the organization's governing body constitutes a central board of interdenominational strategy developing a common mind, planning united policies, and providing for concerted action resulting in the formation of policies embodying the dictates of each member denomination.

It is held, therefore, that the *X* federation of churches is a religious organization of the type contemplated by section 408.215 of Regulations 128, and that services performed for it in an executive or administrative capacity are in the control, conduct, and maintenance of such organization. Accordingly, such services performed by a duly ordained, commissioned, or licensed minister of a church are in the exercise of his ministry and excepted from "employment" under the Federal Insurance Contributions Act.

Section 1402(c) of the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954) provides that 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 of the 1954 Code (relating to trade or business expenses), except that such term shall not include—

* * * * * * *

(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 * * * Christian Science practitioner; * * *.

In view of the above-quoted provisions of law, the performance of services by duly ordained, commissioned, or licensed ministers of churches in the exercise of their ministry or by members of religious orders in the exercise of duties required by such orders, and individuals in the exercise of their profession as Christian Science practitioners, are specifically excluded from the term "trade or business" for purposes of the tax imposed by the Self-Employment Contributions Act of 1954. Consequently, these individuals may remain exempt from liability for the self-employment tax with respect to such services. However, effective for taxable years ending after 1954, section 1402(e) of the Self-Employment Contributions Act of 1954, as added by the Social Security Amendments of 1954, provides that any individual who is (A) a duly ordained, commissioned, or licensed minister of a church or member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order), or (B) a Christian Science practitioner, may elect self-employment coverage of such services within the period prescribed in that section. The election may be exercised by executing and filing Form 2031, Waiver Certificate for Use by Ministers, Certain Members of Religious Orders, and Christian Science Practitioners Electing Coverage under Title II of the Social Security Act. If the election is so made, the individual's wages, if any, for employee services performed as a minister, member of a religious order, or Christian Science practitioner, must be taken into account in determining his liability for the self-employment tax.

(Also Section 501.) Rev. Rul. 56–188

The exception from "employment" provided by section 3121(b)(8)(B) of the Federal Insurance Contributions Act applies to all services performed by employees of an organization described in section 501(c)(3) of the Internal Revenue Code of 1954 which is exempt from Federal income tax under section 501(a) of the Code, including any services performed by employees in the conduct of unrelated activities.

An organization, which is exempt from the payment of Federal income tax under section 501(a) of the Internal Revenue Code of 1954 as an organization described in section 501(c)(3) of the Code, derives a portion of its income from certain unrelated activities. Advice has been requested whether services performed by its employees in connection with such unrelated activities are excepted from "employment" under section 3121(b)(8)(B) of the Federal Insurance Contributions Act.

Section 3121(b)(8)(B) of the Federal Insurance Contributions Act excepts from the term "employment" services performed in the employ of an organization described in section 501(c)(3) of the 1954 Code which is exempt from income tax under section 501(a) of the 1954 Code. The exception is applicable to the exempt organization as a whole rather than separately to its component parts or activities.

Accordingly, it is held that all of the services performed for the exempt organization by its employees, including the services performed in the conduct of its unrelated activities, are excepted from "employment" under section 3121(b)(8)(B) of the Federal Insurance Contributions Act, and the remuneration for such services is not subject to the taxes imposed under the Act.

(Also Section 3306.) Rev. Rul. 56–224

A school organized as a private nonprofit corporation under a state statute to promote the education of deaf mutes, although it receives its financial support from the state and carries on its educational program under state supervision, is not considered a wholly-owned state instrumentality within the meaning of section 3121(b)(7) of the Federal Insurance Contributions Act.

Advice has been requested whether or not a school organized and operated under the circumstances described below is a wholly-owned instrumentality of a state for purposes of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954).

The school was incorporated under an act providing for the incorporation of benevolent, charitable, scientific and missionary societies. Its purpose is promoting the education of deaf mutes. At the time of incorporation, certain sums of money and a tract of land were donated to the school by local citizens. These donations proved inadequate. The state in which the school is located then donated a substantial sum of money to it in consideration of an indenture entered into between the state and the school whereby the latter agreed

to "grant, bargain, sell, lease, convey and confirm to the State" all of the land originally donated to it. That conveyance will take effect only upon the dissolution of the corporation or whenever it ceases to use the premises and the land, or any portion thereof, for the original purposes for which the school was organized. Neither of such contingencies has occurred. The money appropriated by the state was used for the construction of the presently used main school building.

The particular state involved has a program for the over-all supervision of the education of the deaf and administers that supervision through one of its agencies. Another of its agencies sets the standards, aims and practices of a child care program which it administers. The operations of the school come within the jurisdiction of both agencies. The school is required to report annually to both of those agencies and to the state legislature. All of its operational income is derived from state funds through appropriations by the legislature and the school submits an annual budget to those agencies for submission to and approval by the legislature.

All of the business and other affairs of the school are directed by a board of trustees. Membership to that board is accomplished by election at the annual meetings of the members. Any person may become a member upon presentation to and election by the board of trustees. The board of trustees elects an executive committee to carry on and actually manage the business and affairs of the school. A superintendent has been appointed by this committee and he serves as the operating executive of the school.

Section 3121(b) of the Federal Insurance Contributions Act contains the following exception from "employment," as that term is defined in the Act:

> (7) Service * * * performed in the employ of a State, or any political subdivision thereof, or any instrumentality of any one or more of the foregoing which is wholly owned by one or more States or political subdivisions; * * *

Since the school derives all of its operational income through legislative appropriations, it is required to meet certain standards of eligibility set by the state and is subject to a certain amount of supervision by state agencies. However, it appears that the school was established as a private institution with full corporate powers and is operated under the direction of a board of trustees elected by the members of the corporation at its annual meetings. Accordingly, it is concluded that the school is not a wholly-owned instrumentality within the meaning of section 3121(b)(7) of the Federal Insurance Contributions Act; and this conclusion is also applicable with respect to the provisions of the Federal Unemployment Tax Act (chapter 23, subtitle C, of the Code).

Therefore, its status for purposes of the Federal Insurance Contributions Act will depend on whether it is exempt from Federal income taxes under the provisions of section 501(a) of the Code, as an organization described in section 501(c)(3) thereof and, if so, whether it has a waiver of exemption certificate currently on file as provided by section 3121(k) of the Act. In the absence of the establishment of such exemption, the school is an employer subject to the provisions of the Federal Insurance Contributions Act.

Porter employed in a barber shop and operating a shoe shine stand therein as a separate trade or business. See Rev. Rul. 56-66, page 432.

Status of a school bus operator operating his bus under a contract with a school board. See Rev. Rul. 56-172, page 434.

Benefits paid pursuant to a supplemental unemployment benefit plan. See Rev. Rul. 56-249, page 488.

CHAPTER 22.—RAILROAD RETIREMENT TAX ACT

SUBCHAPTER D.—GENERAL PROVISIONS

SECTION 3231.—DEFINITIONS

(Also Part II, section 1532; Regulations 114, Section 411.202.) Rev. Rul. 56-27

The *M* railway association, an organization controlled and maintained principally by two or more carriers by railroad subject to part I of the Interstate Commerce Act, is engaged in promoting the use of better systems, procedures, and methods within the railroad industry. *Held*, the association is an employer for purposes of the taxes imposed by the Railroad Retirement Tax Act.

The Internal Revenue Service has been requested to determine the status, under the Railroad Retirement Tax Act (chapter 22, subtitle C, Internal Revenue Code of 1954), of the *M* railway association, an unincorporated organization sponsored by several carriers by railroad subject to part I of the Interstate Commerce Act and other companies for the purpose of promoting the use of better systems, procedures, and methods within the railroad industry.

The present objective of the *M* railway association is to standardize paper work procedures with the hope that such standardization may bring substantial benefits to all railroads. The fields in which the association is working, or in which it intends to work, include interline freight settlements, billing for repairs to foreign freight cars, train and car movement information, way billing, passing reports, improved communications, better car distributions, and other matters of general interest to the railroad industry.

The membership of the association is composed principally of employees of interested railroad carriers. However, employees of companies having a direct or indirect relationship to the railroad industry are also included as members. No carrier by railroad or other company may become a member of the association but any carrier or other company may become a sponsor.

More than fifty-one percent of the association's revenues are derived from sponsors' fees paid by railroad carriers. Although membership in the association is limited to individuals, more than ninety

percent of its members are officers or employees of carriers by railroad subject to part I of the Interstate Commerce Act and such carriers by railroad have the power to control more than sixty percent of the votes on any question at issue before the association.

Section 3231(a) of the Railroad Retirement Tax Act, in defining an "employer," provides, in part, as follows:

(a) EMPLOYER.—For purposes of this chapter [chapter 22, subtitle C, Internal Revenue Code of 1954], the term "employer" means any carrier (as defined in subsection (g)) [an express company, sleeping-car company, or carrier by railroad, subject to part I of the Interstate Commerce Act] * * *. The term "employer" shall also include * * * organizations controlled and maintained wholly or principally by two or more employers as hereinbefore defined and engaged in the performance of services in connection with or incidental to railroad transportation; * * *.

It is evident that the *M* railway association is engaged in the performance of services "incidental to railroad transportation." Furthermore, the facts support a conclusion that the association is "controlled and maintained * * * principally by two or more employers" [carriers by railroad subject to part I of the Interstate Commerce Act]. Accordingly, the *M* railway association qualifies as an "employer" within the meaning of that term as defined in the Railroad Retirement Tax Act and, therefore, is subject to the provisions of that Act and is liable for the taxes imposed by it.

CHAPTER 23.—FEDERAL UNEMPLOYMENT TAX ACT

SECTION 3306.—DEFINITIONS

Rev. Rul. 56–110

Where a business enterprise of an Indian tribe was not organized by specific statutory authorization of the Congress of the United States and is not operated by the Department of the Interior, but was organized and is operated by the tribe itself with the approval and under the supervision and control of the Bureau of Indian Affairs of the Department of the Interior, such enterprise does not constitute an instrumentality wholly owned by the United States within the meaning of section 3306(c)(6) of the Federal Unemployment Tax Act (chapter 23, subtitle C, Internal Revenue Code of 1954). Such an activity is considered a tribal enterprise and services performed in its employ are not excepted from "employment" under such section.

(Also Sections 61, 3121, 3401.) Rev. Rul. 56–249

Under certain circumstances, benefits paid to individuals by trustees of a trust created pursuant to the provisions of a supplemental unemployment benefit plan established by *M* Company do not constitute "wages" for purposes of the taxes imposed by the Federal Unemployment Tax Act and the Federal Insurance Contributions Act, or for purposes of the Collection of Income Tax at Source on Wages. However, such benefits are includible in the gross incomes of such individuals for the year in which received.

Advice is requested whether benefits paid, under certain circumstances, to individuals by trustees of a trust created pursuant to the provisions of a supplemental unemployment benefit plan established by *M* Company constitute "wages" for purposes of the taxes imposed under the Federal Unemployment Tax Act and the Federal Insurance Contributions Act, and for purposes of the Collection of Income Tax at Source on Wages (chapters 23, 21, and 24, respectively, subtitle C, Internal Revenue Code of 1954). A further inquiry has been received as to whether such benefits paid by the trustees are includible in the gross incomes of the recipients.

Under section 3306(b) of the Federal Unemployment Tax Act, the term "wages" means, with certain exceptions not here material, all remuneration for "employment." The term "employment," as defined in section 3306(c) of such Act, means any service performed by an employee for the person employing him, with certain exceptions and limitations.

Pursuant to an agreement entered into with *O* Labor Union, The *M* Company established a plan designed to supplement State system unemployment benefits payable to certain former employees of *M* Company who have been laid off by the Company by reason of a reduction in force or the discontinuance of a plant or an operation.

Under the terms of the plan, *M* Company is to make, for each pay period, a contribution to a fund held and administered by an independent trustee equal to *x* cents, multiplied by the total number of hours for which its eligible employees shall have received pay from the company for such pay period. The company's obligation to make such contributions ceases, however, whenever the total of amounts held by the trustee in the fund equals a maximum level determinable under the terms of the plan. The size of the fund created under the plan is limited to a specified maximum amount, such amount being dependent upon the number of employees who are in the active service of *M* Company and the number of laid-off employees who have credit units under the plan. No employee of *M* Company has any right, title, or interest in or to any of the assets of the fund or in or to any Company contribution thereto unless and until he is qualified and eligible to receive a benefit therefrom. *M* Company's contributions will be irrevocable; and *M* Company will not have any ownership therein during the ordinary operation of the plan, or in the assets comprising the fund. Legal title to said assets, as well as to Company contributions, rests in the trustee, who will use the assets solely in the interests of the employees. Upon a termination of the plan, the amounts in the fund will be used to pay benefits to employees already or subsequently laid off. The fund is the sole source of benefit payments. *M* Company is required to make specified payments to the fund but is in no way liable for additional contributions to such fund or otherwise, or for the payment of benefits should the assets of such fund prove insufficient.

The benefits payable from the fund are to be in varying amounts and for varying periods, depending on the size of the fund, duration of layoff of an employee, time worked prior to layoff, amount of State unemployment benefits available, and the base hourly-rate of the individual employee, less taxes withheld. Generally, the benefits

payable under the plan to a beneficiary in a State where the amount thereof will not reduce or cancel State unemployment benefits shall be such sum which, together with the State unemployment compensation benefit and other remuneration (which cannot be in an amount equal to or in excess of that amount which would disqualify the beneficiary for such State benefit), equals the lesser of (a) a prescribed percentage of the employee's current straight-time weekly pay after withholding of all taxes and contributions, or (b) w dollars.

The duration of benefits to an individual under the plan is related to, among other factors, the number of credit units which the individual has accumulated by reason of his service with M Company. For each week worked subsequent to the effective date of the plan, each employee is credited with z units; but he shall never accumulate more than $52\,z$ units. For each weekly benefit received under the plan, an individual is charged a number of accumulated credit units, such charge being governed by (a) the level of the fund at the time of such payment and, if such level is not equal to the maximum level prescribed, (b) the number of years during which the individual worked for M Company. That is, if the level of the fund is equal to the prescribed maximum, all eligible individuals under the plan are charged the same number of accumulated credit units for each weekly benefit. If, however, the level of the fund is less than the maximum (but more than a minimum below which no payments may be made from the fund), the number of accumulated credit units charged an eligible individual for each weekly benefit payment is determined on the basis of the number of years of continuous service with M company. No benefit can be paid from the fund to any individual who has no available credit units. Any unused credit units are cancelled at the expiration of y months of continuous layoff.

The plan specifies the particular conditions under which benefits are payable. Benefits are paid only to former employees who have been laid off because of certain enumerated conditions such as a reduction of the working force or the discontinuance of a plant by M Company. Furthermore, benefits are payable only after a "waiting period" of v weeks. However, neither layoff nor resulting unemployment alone is sufficient to entitle a former employee of M Company to benefits. Nor are benefits payable to employees who, although not in a work status during a particular week, are in a "standby" capacity in the sense that their availability for work is limited to M Company.

To be eligible for a benefit, a former employee must report to and register for employment with the State Employment Service. All requirements of State unemployment compensation laws designed to limit the payment of benefits to individuals who are "unemployed" and genuinely available for any suitable work are incorporated as eligibility requirements for the receipt of supplemental unemployment benefits from the fund.

While a prior period of service with the employer is required in order that an individual be eligible for benefits, the mere existence of such prior relationship, as such, does not establish such individual's eligibility for benefits. His eligibility is also dependent on his continu-

ously meeting conditions subsequent to the termination of his employment with *M* Company. During this period of unemployment, an individual must be continuously able to work and available for work and he must continue to meet specific periodic reporting requirements. He must satisfy other specific conditions which are applicable at all times when unemployed. He is ineligible to receive supplemental unemployment benefits from the fund if he is ineligible to receive or is disqualified from receiving State unemployment compensation benefits, except in three limited situations, viz., where he has insufficient wage credits under the State law, where he has exhausted the duration under the State law, or where the State law requires "a waiting period" of more than *v* weeks. But even in such cases, supplemental benefits are payable only if he would otherwise have been eligible for State unemployment compensation and also has complied with the other conditions incorporated in the plan. If by reason of the payment of such supplemental unemployment benefits, however, an individual would be ineligible to receive State unemployment benefits, the plan provides for the payment of a substitute benefit.

Similarly, although payments by *M* Company to the fund are measured in part by total hours worked by all employees, eligibility for benefits does not depend on whether contributions have been made with respect to hours worked by a specific employee. A former employee may receive benefits although no contributions have been made during the entire period of his employment with *M* Company (contributions are not made when the fund reaches a specified level). Conversely, a former employee, on the basis of whose employment contributions have been made to the fund, may not be eligible to receive benefits when unemployed, because of his failure to satisfy the conditions of eligibility during his period of unemployment or because the fund is then below a certain specified level.

Under the plan, the amount of supplemental unemployment benefits paid from the fund is dependent on many conditions. The plan does not provide for a benefit fixed solely on the basis of an individual's prior earnings. The amount of the supplemental unemployment benefit paid from the fund to any former employee depends on the size of the State unemployment benefit to which he is entitled and the amount of other remuneration received which is allowable under State unemployment compensation law, his marital status, the number of his dependents, as well as his wage rate at the time of layoff. An individual who is eligible for a supplemental unemployment benefit will receive a weekly benefit (not in excess of *w* dollars) in the amount necessary to supplement his State unemployment benefit, plus other allowable remuneration received, up to a stated percentage of his straight time take-home pay.

As observed above, the period for which benefits are paid to a laid-off worker who meets the conditions of eligibility is dependent upon the fund position. When the program is in full operation with the fund at the maximum level, all employees with one or more years of continuous employment with *M* Company since the effective date of the plan are entitled to the same potential duration of benefits. However,

if the fund position is less than a stated percentage, the laid-off employee's seniority becomes a factor in determining the period for which benefits are paid.

An analysis of the information presented discloses that pursuant to the supplemental unemployment benefit plan (1) the benefits are paid only to unemployed former employees of *M* Company who are on layoff from the Company; (2) eligibility for benefits depends on the meeting of prescribed conditions subsequent to the termination of the employment relationship with *M* Company; (3) benefits are paid by the trustees of independent trust funds; (4) the amount of a weekly benefit payable under the plan is based upon (a) the amount of the weekly benefit payable under the appropriate State unemployment compensation laws, (b) the amount of other remuneration allowable under such State unemployment compensation laws, and (c) the amount of straight-time weekly pay after withholding of all taxes and contributions; (5) the duration of weekly benefits payable under the plan depends upon a combination of (a) the number of accumulated credited units, and (b) the fund position; (6) a right, if any, to benefits does not accrue until a prescribed period after the termination of the employment relationship with *M* Company has elapsed; (7) the benefits ultimately paid are not attributable to the rendering of particular services by the recipient during the period of his employment; and (8) no employee has any right, title, or interest in or to any of the assets of the fund or in or to any Company contributions thereto until such time as he is qualified and eligible to receive a benefit therefrom.

In view of the foregoing, and on the basis of all the facts and circumstances set forth herein, it is concluded that the benefits paid to former employees of *M* Company under the terms of the supplemental unemployment benefit plan do not constitute "wages" for purposes of the Federal Unemployment Tax Act.

It is also concluded that the benefits paid to former employees of *M* Company under the terms of the supplemental unemployment benefit plan do not constitute "wages" for purposes of the Federal Insurance Contributions Act and the Collection of Income Tax at Source on Wages.

Notwithstanding the foregoing conclusions, it is further held that the benefits paid to former employees of *M* Company under the terms of the supplemental unemployment benefit plan are includible in the gross incomes of such former employees for Federal income tax purposes for the year in which received.

Services performed by employees of a company in dehydrating and grinding alfalfa grown on its farm. See Rev. Rul. 56–53, page 456.

A determination of whether a school organized as a private nonprofit corporation and subject to state supervision is a wholly owned state instrumentality. See Rev. Rul. 56–224, page 485.

CHAPTER 24.—COLLECTION OF INCOME TAX AT SOURCE ON WAGES

SECTION 3401.—DEFINITIONS

26 CFR 31.3401(a)–1: Statutory provisions; Definitions; Wages. T. D.6155 [1]

(Also Sections 6001, 6051; 26 CFR 31.6001–5, 31.6051–1.)

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER C, PART 31.—EMPLOYMENT TAXES; APPLICABLE ON AND AFTER JANUARY 1, 1955

Regulations under sections 3401(a), 6001, and 6051 of the Internal Revenue Code of 1954.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

AUTHORITY: §§ 31.3401(a) to 31.6051–1, inclusive, issued under secs. 6051, 7805, I. R. C. 1954; 68A Stat. 747, 917; 26 U. S. C. 6051, 7805.

On October 12, 1955, a notice of proposed rulemaking regarding the regulations under sections 3401(a), 6001, and 6051 of the Internal Revenue Code of 1954 was published in the Federal Register (20 F. R. 7610) in order to provide rules with respect to payments made after December 31, 1955, of amounts subject to section 105(d) of the 1954 Code. After consideration of the relevant suggestions presented by interested parties regarding the proposed rules, the following regulations are hereby adopted:

§ 31.3401(a) STATUTORY PROVISIONS; DEFINITIONS; WAGES.

SEC. 3401. DEFINITIONS.

(a) WAGES.—For purposes of this chapter, the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash; except that such term shall not include remuneration paid—* * *

§ 31.3401(a)–1 WAGES—* * *

(b) *Certain specific items*—* * *

(8) *Amounts paid under wage continuation plans*—* * *

(ii) *Amounts paid after December 31, 1955—(a) In general.*—The term "wage continuation payment", as used in this subdivision, means any payment to an employee which is made after December 31, 1955, under a wage continuation plan (as defined in § 1.105–4(a) of the Income Tax Regulations (26 CFR part 1)) for a period of absence from work on account of personal injuries or sickness, to the extent such payment is attributable to contributions made by the employer which were not includible in the employee's gross income or is paid by the employer. Any such payment, whether or not excluded from the gross income of the employee under section 105(d), con-

[1] 20 F. R. 10097.

stitutes "wages" (unless specifically excepted under any of the numbered paragraphs of section 3401(a) or under section 3402(e)) and withholding thereon is required except as provided in (*b*) and (*c*) of this subdivision.

(*b*) *Amounts paid by employer for whom services are performed.*—Withholding is not required with respect to any or all employees upon the amount of any wage continuation payment made to an employee directly by the employer for whom he performs services to the extent that such payment is excludable from the gross income of the employee under section 105(d), provided the records maintained by the employer—

(*1*) Separately show the amount of each such payment and the excludable portion thereof, and

(*2*) Contain data substantiating the employee's entitlement to the exclusion provided in section 105 (d) with respect to such amount, either by a written statement from the employee specifying whether his absence from work during the period for which the payment was made due to a personal injury or whether such absence was due to sickness, and, if the latter, whether he was hospitalized for at least one day during this period; or by any other information which the employer reasonably believes establishes the employee's entitlement to the exclusion under section 105 (d).

Employers shall not be required to ascertain the accuracy of the information contained in any written statement submitted by an employee in accordance with (*2*) above. For purposes of this subdivision, computation of the amount excludable from the gross income of the employee under section 105(d) may be made either on the basis of the wage continuation payments which are made directly by the employer for whom the employee performs services, or on the basis of such payments in conjunction with any wage continuation payments made on behalf of the employer by a person who is regarded as an employer under section 3401(d)(1).

(*c*) *Amounts paid by person other than the employer for whom services are performed.*—No tax shall be withheld upon any wage continuation payment made to an employee by or on behalf of a person who is not the employer for whom the employee performs services but who is regarded as an employer under section 3401(d)(1). For example, no tax shall be withheld with respect to wage continuation payments made on behalf of an employer by an insurance company under an accident or health policy, by a separate trust under an accident or health plan, or by a State agency from a sickness and disability fund maintained under State law.

(*d*) *Cross references.*—See sections 6001 and 6051 and the provisions thereunder in subpart G of the regulations in this part for rules with respect to the records which must be maintained in connection with wage continuation payments and for rules with respect to the statements which must be furnished an employee in connection with wage continuation payments, respectively. See also section 105 and the provisions thereunder in the Income Tax Regulations (26 CFR part 1).

§ 31.6001 Statutory Provisions; Notice or Regulations Requiring Records, Statements, and Special Returns.

SEC. 6001. NOTICE OR REGULATIONS REQUIRING RECORDS, STATEMENTS, AND SPECIAL RETURNS.

Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgment of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title.

§ 31.6001–5 ADDITIONAL RECORDS IN CONNECTION WITH COLLECTION OF INCOME TAX AT SOURCE ON WAGES.—(a) Every employer required under section 3402 to deduct and withhold income tax upon the wages of employees shall keep records of all remuneration paid to such employees. Such records shall show with respect to each employee—

* * * * * * *

(12) In the case of the employer for whom services are performed, with respect to payments made directly by him after December 31, 1955, under a wage continuation plan (as defined in § 1.105–4(a) of the Income Tax Regulations (26 CFR part 1))—

(i) The beginning and ending dates of each period of absence from work for which any such payment was made; and

(ii) Sufficient information to establish the amount and weekly rate of each such payment.

§ 31.6051 STATUTORY PROVISIONS; RECEIPTS FOR EMPLOYEES.

SEC. 6051. RECEIPTS FOR EMPLOYEES.

(a) REQUIREMENT.—Every person required to deduct and withhold from an employee a tax under section 3101 or 3402, or who would have been required to deduct and withhold a tax under section 3402 if the employee had claimed no more than one withholding exemption, shall furnish to each such employee in respect of the remuneration paid by such person to such employee during the calendar year, on or before January 31 of the succeeding year, or, if his employment is terminated before the close of such calendar year, on the day on which the last payment of remuneration is made, a written statement showing the following:

(1) The name of such person,

(2) The name of the employee (and his social security account number if wages as defined in section 3121(a) have been paid),

(3) The total amount of wages as defined in section 3401(a),

(4) The total amount deducted and withheld as tax under section 3402,

(5) The total amount of wages as defined in section 3121(a), and

(6) The total amount deducted and withheld as tax under section 3101.

(b) SPECIAL RULE AS TO COMPENSATION OF MEMBERS OF ARMED FORCES.—In the case of compensation paid for service as a member of the Armed Forces, the statement shall show, as wages paid during the calendar year, the amount of such compensation paid during the calendar year which is not excluded from gross income under chapter 1 (whether or not such compensation constituted wages as defined in section 3401(a)); such statement to be furnished if any tax was withheld during the calendar year or if any of the compensation paid is includible under chapter 1 in gross income.

(c) ADDITIONAL REQUIREMENTS.—The statements required to be furnished pursuant to this section in respect of any remuneration shall be furnished at such other times, shall contain such other information, and shall be in such form as the Secretary or his delegate may by regulations prescribe.

(d) STATEMENTS TO CONSTITUTE INFORMATION RETURNS.—A duplicate of any statement made pursuant to this section and in accordance with regulations prescribed by the Secretary or his delegate shall, when required by such regulations, be filed with the Secretary or his delegate.

§ 31.6051–1 STATEMENTS FOR EMPLOYEES.—(a) *Requirement if wages are subject to withholding of income tax.*—(1) *General rule.* * * *

(iii) In the case of statements furnished by the employer for whom services are performed, with respect to wages paid after December 31, 1955, "the total amount of wages as defined in section 3401(a)", as used in section 6051(a)(3), shall include all payments made directly by such employer under a wage continuation plan which constitute wages in accordance with § 31.3401(a)–1(b)(8)(ii)(*a*), without regard to whether tax has been withheld on such amounts.

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved December 27, 1955.

H. CHAPMAN ROSE,
Acting Secretary of the Treasury.

(Filed by the Division of the Federal Register December 29, 1955, 8:49 a. m.)

(Also Section 1402.)
(Also Part II, Sections 481(a), 1621(c);
Regulations 118, Section 39.481–1;
Regulations 120, Section 406.203.)

Rev. Rul. 56–2

An individual examines state income tax returns for two municipalities of a state, on a yearly contract basis, to see that income taxes allocable to the respective municipalities under state statute are paid to them and not to other municipalities. He also prepares the necessary papers pertinent to the filing of claims to recover taxes erroneously allocated and is remunerated in an amount equal to 15 percent of all monies recovered. He is not furnished desk or office space or other conveniences by the municipalities and is not carried on their payrolls. His work is performed partly at the county courthouse and partly in his own home. He determines his own working hours and the amount of time which he will devote to the work. The municipalities agree not to enter into similar contracts with other individuals during the life of the respective contracts. The contracts are automatically renewed each year unless either party notifies the other of intention not to renew. *Held*, the individual is not an employee of the municipalities for Federal income tax withholding purposes.

Such activity constitutes a "trade or business," the income from which is includible in computing net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954.

An inquiry has been received relative to the status, for purposes of the Collection of Income Tax At Source On Wages (chapter 24, subtitle C, Internal Revenue Code of 1954), and the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954), of an individual performing certain services for two municipalities of a state under the circumstances described below.

Under the term of similar one-year contracts entered into with the municipalities, the individual agrees to act in their behalf in making an inspection of all of the state income tax returns filed by indi-

viduals, partnerships and corporations, whether residing within the respective municipalities or elsewhere, to see that income taxes which are allocable under state statute to such municipalities are paid to them and not to other municipalities not entitled to receive them. The individual further agrees to prepare the necessary petitions, papers, and other data pertaining to the filing of claims for the recovery of taxes erroneously allocated or paid to other municipalities, and is remunerated in an amount equal to 15 percent of all monies recovered. The municipalities each agree not to enter into a like contract with any other person for such services. The contracts are automatically renewed each year unless either party, within ninety days prior to the expiration date thereof, notifies the other in writing of an intention not to renew. The municipalities do not furnish office space or other conveniences to the individual and do not carry him on their payrolls. His work is done partly at the county courthouse and partly in his own home. He determines his own working hours and spends his time as he pleases in the interest and progress of the work.

Section 406.203 of Regulations 120, applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision 6091, C. B. 1954–2, 47, sets forth certain guides to be used in determining whether, for Federal income tax withholding purposes, the legal relationship of employer and employee exists. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.

The facts in the instant case, namely, that the individual is not required to perform his services on the premises or under the supervision of the municipalities, is not required to observe particular hours, is not controlled as to the manner in which the work should be done, and is required under the contracts only to show accomplished results, indicate that the municipalities do not exercise the control or direction necessary to establish an employer-employee relationship for Federal income tax withholding purposes. In addition, the municipalities have not reserved any rights under the contracts to exercise such control or direction over the manner in which he performs his services. Accordingly, he is not an employee of the municipalities for such purposes.

Section 1402 of the Self-Employment Contributions Act of 1954 provides in part:

> (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 [subtitle A] which are attributable to such trade or business, * * *
>
> * * * * * * *
>
> (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 * * *.

As a general rule, when a person is regularly engaged in an occupation or profession for profit which constitutes, in whole or in part, his livelihood and, as to such occupation or profession, is not regarded as an employee for Federal income tax withholding purposes or otherwise excluded from the self-employment tax provisions, he is engaged in a "trade or business."

Under the circumstances stated herein, it is concluded that the individual is engaged in a "trade or business" with respect to the services rendered to the municipalities in the examination of state income tax returns and the preparation of claims in connection therewith. Accordingly, the income derived from such services should be taken into consideration in computing net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954.

(Also Part II, Section 1621(b); Regulation 120, Section 406.301.) Rev. Rul. 56–272

An employee having an established weekly payroll period works only on two days during one such period. *Held* absence for a portion of a payroll period does not change such period from a weekly to a daily or other period for income tax withholding purposes.

Advice has been requested whether the income tax required to be withheld, pursuant to section 3402 of the Internal Revenue Code of 1954, from wages paid with respect to a weekly payroll period should be prorated in proportion to the actual number of days the employee performed services during such period.

An individual regularly employed by an employer on an established weekly payroll basis was absent from work on three days of a certain week. In determining the amount of income tax to be withheld from the wages paid for the week during which the employee worked only two days, the employer deducted two-fifths of the amount of tax shown in the wage bracket table for a weekly payroll period based on the wages the employee would have received had he performed services for five days.

Section 406.301(b) of Regulations 120, made applicable under the Internal Revenue Code of 1954 by Treasury Decision 6091, C. B. 1954–2, 47, provides that for purposes of income tax withholding an employee can have but one payroll period with respect to wages paid by any one employer.

It is held that in determining the amount of tax required to be withheld in the instant case, the amount of wages subject to withholding paid to the employee for the week during which he worked two days constitutes his weekly wage for such week and that since his employer had established a regular weekly payroll period, the tax should be withheld on that basis even though the employee did not work for the full period.

The application of the wage bracket method of withholding is illustrated in the following example:

Example.—If the employee in the instant case has two withholding exemptions and is paid regular weekly wages of $80, the employer would be required to deduct the sum of $10 from his weekly wages. However, if such employee works only two days during a particular week and receives wages of $32 therefor, the employer would be required to deduct only the sum of $1.20, rather than two-fifths of $10, or $4.

Remuneration for harvesting and packing lettuce. See Rev. Rul. 56–35, page 453.

Services performed by a securities salesman. See Rev. Rul. 56-69, page 458.

Remuneration for "agricultural labor." See Rev. Rul. 56-118, page 467.

"Dealers" engaged in distributing bakery products to customers under a contract with a baking company. See Rev. Rul. 56-129, page 470.

Benefits paid pursuant to a supplemental unemployment benefit plan. See Rev. Rul. 56-249, page 488.

Reporting sick and injury pay excludable from gross income under section 105(d) of the Internal Revenue Code of 1954. See Rev. Proc. 56-17, page 1042.

SECTION 3402.—INCOME TAX COLLECTED AT SOURCE

Rev. Rul. 56-37

Remuneration paid on or after August 9, 1955, for services performed in a possession of the United States by a citizen of the United States for an employer other than the United States or any agency thereof is not subject to withholding of income tax for the United States, if the employer is required by the law of any foreign country or possession of the United States to withhold income tax upon such remuneration.

The purpose of this Revenue Ruling is to inform employers and employees of the effect of the Act of August 9, 1955, Public Law 321, 84th Cong., 68A Stat. 455, 26 USC 3401, C. B. 1955-2, 761, 37, on the income tax withholding requirements set forth in section 3402 of the Internal Revenue Code of 1954.

Section 3402 of the 1954 Code requires that every employer making payment of wages shall withhold income tax upon such wages in accordance with the provisions of that section. Section 3401(a) of the Code defines the term "wages" for purposes of the income tax withholding required under section 3402 of such Code. Public Law 321, *supra*, amends paragraph (8)(A) of section 3401(a) of the Code, effective with respect to remuneration paid on or after August 9, 1955. Section 3401(a)(8)(A) as so amended provides as follows:

Section 3401. DEFINITIONS.

(a) WAGES.—For purposes of this chapter, the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash; except that such term shall not include remuneration paid—

* * * * * * *

(8)(A) for services for an employer (other than the United States or any agency thereof)—

(i) performed by a citizen of the United States if, at the time of the payment of such remuneration, it is reasonable to believe that such remuneration will be excluded from gross income under section 911; or

(ii) performed in a foreign country *or in a possession of the United States* by such a citizen if, at the time of the payment of such remuneration, the employer is required by the law of any foreign country or *possession of the United States* to withhold income tax upon such remuneration; * * * (Italics supplied).

The italicized language of the section above was inserted by Public Law 321, *supra*. The effect of inserting such language is to except from "wages," as that term is defined for purposes of the withholding required under section 3402 of the 1954 Code, any remuneration paid on or after August 9, 1955, to a citizen of the United States for services performed in a possession of the United States for an employer other than the United States or any agency thereof if, at the time of payment, income tax must be withheld from such remuneration pursuant to the law of any foreign country or possession of the United States.

Accordingly, any such employer who is required by the law of any foreign country or possession of the United States to withhold income tax from the remuneration paid United States citizens on or after August 9, 1955, for services performed in a possession of the United States should not also withhold income tax from that same remuneration in behalf of the United States.

Circular E, Employer's Tax Guide (revised January 1955) is hereby amended to the extent necessary to bring the Circular into conformity with the provisions of Public Law 321, *supra*.

The determination as to whether income earned in a foreign country or possession of the United States is includible in gross income, for purposes of the income tax, is not affected by Public Law 321, *supra*.

SUBTITLE D.—MISCELLANEOUS EXCISE TAXES

CHAPTER 31.—RETAILERS EXCISE TAX

SUBCHAPTER A.—JEWELRY AND RELATED ITEMS

SECTION 4001.—IMPOSITION OF TAX

Rev. Rul. 56–273

A quantity of jewelry and related items were delivered on consignment by the owner to an auction gallery to be sold at public auction. The top bid price for the items did not meet the expectations of the owner. Therefore, the owner reacquired such items as the highest bidder. *Held*, as there is no transfer of title with respect to an article delivered on consignment for sale at auction and bid in by the owner, no sale occurs. Accordingly, the retailers excise tax on jewelry and related items, imposed by section 4001 of the Internal Revenue Code of 1954, does not apply to the instant transaction.

Procedure whereby a retailer of articles subject to retailers excise tax may compute and prepay the tax at the time the taxable articles are purchased. See Rev. Rul. 56–261, page 556.

SUBCHAPTER B.—FURS

SECTION 4011.—IMPOSITION OF TAX

Rev. Rul. 56-291

A retail furrier makes shoe mitts from used fur to be used as shoe dusters, and has announced that each person who leaves a fur coat with him for storage will receive a pair of these mitts. *Held*, the shoe mitts are considered to be articles made of fur which, when sold at retail, are subject to the retailers excise tax imposed by section 4011 of the Internal Revenue Code of 1954. Where the mitts are issued to a person who leaves a fur coat with the furrier for storage, they are part of the consideration passing between the parties and, therefore, the transaction is considered to be a taxable sale of the fur mitts. In the absence of a retail selling price established by separate sales at retail, the tax should be computed on the retail value of the fur mitts.

Procedure whereby a retailer of articles subject to retailers excise tax may compute and prepay the tax at the time the taxable articles are purchased. See Rev. Rul. 56-261, page 556.

SUBCHAPTER C.—TOILET PREPARATIONS

SECTION 4021.—IMPOSITION OF TAX

Procedure whereby a retailer of articles subject to retailers excise tax may compute and prepay the tax at the time the taxable articles are purchased. See Rev. Rul. 56-261, page 556.

SUBCHAPTER D.—LUGGAGE, HANDBAGS, ETC.

SECTION 4031.—IMPOSITION OF TAX

Rev. Rul. 56-243

The retailers' excise tax on luggage, handbags, etc., applies to carrying cases fitted with boxes, jars, or tubes, for holding lotions, creams, powders, or other toilet articles even though the cases do not contain, nor have room for, combs, hair brushes, manicuring implements, or similar articles.

Advice has been requested concerning the application of the retailers' excise tax on luggage, handbags, etc., imposed by section 4031 of the Internal Revenue Code of 1954, to the sale of carrying cases fitted with boxes, jars, or tubes, for holding lotions, creams, powders, or other toilet preparations. The cases do not contain, nor do they have room for, combs, hair brushes, manicuring implements, or similar articles.

The tax imposed by section 4031 of the Code is specifically applicable to toilet cases, and to other cases, bags, and kits, without regard to their size, shape, construction, or material from which made, for use in carrying toilet articles or articles of wearing apparel. The tax attaches also to the fittings or accessories sold on or in connection with the sale of the cases, bags, or kits.

It has heretofore been the position of the Internal Revenue Service that carrying cases fitted with boxes, jars, or tubes, for holding lotions, creams, powders, etc., were not taxable unless the cases contained, or had room for, toilet articles such as combs, hair brushes, manicuring implements, etc. This position was based on the conclusion that lotions, creams, powders, etc., were "toilet preparations" rather than "toilet articles" and that provision for carrying such preparations did not make the cases taxable.

Upon further consideration the Service has concluded that lotions, creams, powders and other toilet preparations, as well as combs, hair brushes, manicuring implements, etc., constitute toilet articles within the meaning of section 4031 of the Code.

The selection by Congress and taxation of a group of articles by section 4021 of the Code under the heading "Toilet Preparations" does not create any distinction between toilet preparations and toilet articles for the purposes of the tax under section 4031 of the Code. The term "toilet articles" as used in section 4031 embraces all toilet preparations whether or not they are taxable under section 4021. In other words, items such as shampoo, tooth paste, bath or toilet soap, which are not taxable under section 4021, are considered "toilet articles" in determining whether a case for use in carrying such items is taxable. Thus, the term "toilet article" as used in section 4031 includes all articles designed or used for toilet purposes without regard to whether they are within the taxable categories enumerated in section 4021 of the Code.

Accordingly, it is held that the tax on luggage, handbags, etc., imposed by section 4031 of the Code, applies to the sale at retail of the above-described carrying cases fitted with boxes, jars, or tubes for holding lotions, creams, powders, or toilet articles whether or not the cases contain, or have room for, combs, hair brushes, manicuring implements, or similar articles.

Since the position stated herein represents a departure from the position previously taken by the Service in rulings issued to retailers, it has been concluded that, under the authority contained in section 7805(b) of the Code, the instant ruling will not be applied retroactively. In order to give retailers generally an opportunity to accommodate themselves to the ruling, it will be applied prospectively beginning July 1, 1956. On and after that date sales by retailers of cases coming within the scope of the ruling will be subject to tax.

(Also Section 4061.) Rev. Rul. 56–274

A small plastic receptacle which has a magnetized top for attachment to the dashboard of an automobile and is designed and sold solely for the purpose of carrying parking meter coins in the automobile, does not come within the scope of the articles subject to the tax on luggage, handbags, etc., imposed by section 4031 of the Internal

Revenue Code of 1954. Also, a registration card holder designed and sold solely for the purpose of carrying an automobile registration card, driver's permit, etc., on the steering post of an automobile does not come within the scope of the articles subject to the tax imposed by that section. Therefore, the sale by the retailer of such articles is not taxable. However, such articles are considered as parts or accessories for automobiles within the meaning of section 4061(b) of the Code and, as such, are subject to the manufacturers excise tax when sold by the manufacturer, producer, or importer.

Rev. Rul. 56–292

A small plastic round or oval receptacle, approximately two and one-half inches in diameter, which has a slit running the length of one side, which is intended to permit the insertion or removal of coins when the receptacle is squeezed, is considered to be a purse within the meaning of section 4031 of the Internal Revenue Code of 1954 and is subject to the retailers excise tax on luggage, handbags, etc., when sold at retail.

Procedure whereby a retailer of articles subject to retailers excise tax may compute and prepay the tax at the time the taxable articles are purchased. See Rev. Rul. 56–261, page 556.

CHAPTER 32.—MANUFACTURERS EXCISE TAXES

SUBCHAPTER A.—AUTOMOTIVE AND RELATED ITEMS

PART I.—MOTOR VEHICLES

SECTION 4061.—IMPOSITION OF TAX

(Also Part II, Sections 3403, 3444; Regulations 46, Sections 316.4, 316.7.) Rev. Rul. 56–189

The manufacturers excise tax applies to the rebuilder's sale of a reassembled generator containing an armature rewound by the reassembler and to a rebuilt clutch assembly.
Revenue Ruling 55–98 revoked; Revenue Ruling 54–329 modified.

The Internal Revenue Service has reconsidered Revenue Ruling 54–329, C. B. 1954–2, 405, and Revenue Ruling 55–98, C. B. 1955–1, 524, particularly with reference to the taxability of reassembled generators containing armatures rewound by the reassembler and rebuilt clutch assemblies. As a consequence of such reconsideration, the Service has now concluded that the positions taken in these rulings as applied to reassembled generators and rebuilt clutch assemblies are not sound.

Therefore, it is held that the manufacturers excise tax applies to the rebuilder's sale of a reassembled generator containing an arma-

ture rewound by the reassembler, and to a rebuilt clutch assembly. Revenue Ruling 55–98 is revoked and Revenue Ruling 54–329 is modified accordingly.

Because of the reliance which may have been placed on these Revenue Rulings by generator and clutch rebuilders, the instant ruling will not be applied to sales occurring prior to June 1, 1956, except that any tax which may have been paid by generator rebuilders on generators containing armatures rewound by them or by clutch rebuilders will not be refunded.

Rev. Rul. 56–253

Where automobile truck trailers are sold by the manufacturer under conditional sales contracts and the manufacturer discounts the contracts by the sale thereof to a finance company, the tax becomes due and payable on the entire amounts receivable under the contracts regardless of the fact that lesser amounts are actually received by the manufacturer from the finance company.

Rev. Rul. 56–254

A manufacturer of truck trailers is liable for the manufacturers excise tax with respect to sales of repossessed trailers which are reacquired by reason of the prospective purchasers' failure to make payments thereon.

Advice has been requested concerning the applicability of the manufacturers excise tax, imposed by section 4061 of the Internal Revenue Code of 1954, to sales of repossessed truck trailers that had been previously delivered under conditional sales contracts and repossessed by the manufacturer because of the prospective purchasers' failure to make payments thereon.

A manufacturer of truck trailers delivered trailers under conditional sales contracts which provide that payments are to be made in installments. The manufacturer retained title until all the payments are received. Because some prospective purchasers failed to make the required payments, the manufacturer repossessed some of these truck trailers. The manufacturer contends that the repossessed trailers are used merchandise and subsequent sales thereof are not taxable under the provisions of S. T. 867, C. B. 1937–2, 505. S. T. 867 holds that no tax, other than that imposed on the original sale, shall apply to the subsequent resale or use of a used article accepted as a trade-in, unless it is so altered or rebuilt as to lose its identity prior to resale or use by the manufacturer.

The provisions of S. T. 867, *supra*, do not apply to articles repossessed under the terms of conditional sales contracts by reason of the prospective purchasers' failure to make required payments. Under conditional sales contracts title to the articles does not pass to the prospective purchaser. Therefore, the sale is not actually consummated. The type of situation contemplated in S. T. 867, *supra*, involved used articles which were actually sold prior to use and later came back into the manufacturer's possession as trade-ins after the original sales thereof had been consummated on a tax-paid or tax-exempt basis.

Accordingly, it is held that a manufacturer of truck trailers is liable for the manufacturers excise tax on its sale of repossessed trailers which are reacquired by reason of the failure of the prospective purchasers to make required payments thereon.

Rev. Rul. 56–275

As held under prior law in S. T. 626, C. B. XII–1, 387 (1933), fire trucks and fire-fighting apparatus are not, in themselves, subject to the manufacturers excise tax. However, section 4061(a) of the Internal Revenue Code of 1954 imposes the tax upon sales of automobile truck chassis and bodies and specifically provides that the sale of an automobile truck shall be considered a sale of the chassis and of the body. Under the law, therefore, an automobile truck chassis retains its separate identity even though fire-fighting apparatus is mounted upon it. *Held*, the mounting of fire-fighting apparatus upon a taxable chassis does not relieve the chassis manufacturer from payment of the tax. However, a credit or refund of the tax paid on the sale of the chassis is allowable to the chassis manufacturer where the purchaser adds fire-fighting apparatus and resells the chassis to a State or political subdivision, provided the claim for credit or refund is supported by a properly executed exemption certificate in accordance with the regulations. *Held further*, a fire-fighting apparatus cab, which is designed in conjunction with and is physically attached to the pump and fire-fighting apparatus body, is not a part of the taxable truck chassis and is, therefore, not subject to the tax.

Rev. Rul. 56–293

Electric bottle warmers which are primarily designed to operate from a cigarette lighter or similar outlet in an automobile electrical system constitute automobile parts or accessories and are, therefore, subject to the manufacturers excise tax imposed by section 4061(b) of the Internal Revenue Code of 1954.

Advice has been requested concerning the applicability of the manufacturers excise tax to the sale of electric bottle warmers which are designed to operate from a cigarette lighter or similar outlet in an automobile electrical system. The bottle warmers are sold for use in warming liquids for feeding babies while traveling in automobiles or other motor vehicles.

Section 4061(b) of the Internal Revenue Code of 1954 specifies that, in addition to the motor vehicle articles enumerated in section 4061(a), parts or accessories therefor shall also be subject to a manufacturers excise tax. Section 316.55 of Regulations 46, made applicable to the 1954 Code by Treasury Decision 6091, C. B. 1954–2, 47, defines the terms "parts or accessories" for an automobile truck or other automobile chassis or body, or a taxable tractor, as including any article the primary use of which is in connection with such vehicle or article whether or not essential to its operation or use.

Accordingly, it is held that electric bottle warmers, which are primarily designed to operate from a cigarette lighter or similar outlet in an automobile electrical system constitute automobile parts or acces-

sories within the meaning of section 4061(b) of the Code and are, therefore, subject to the manufacturers excise tax imposed by that section.

Application of the tax to (1) a receptacle for carrying parking meter coins, and (2) a holder for carrying a registration card, etc., where such articles are designed to be attached to an automobile. See Rev. Rul. 56-274, page 502.

SECTION 4062.—DEFINITIONS

Rev. Rul. 56-192

In computing the manufacturers excise tax on exchange sales of rebuilt automobile parts (or accessories) by the rebuilder, the law provides, in effect, that the amounts allowed to customers for like used parts accepted in exchange are not to be included in the basis of tax on the rebuilt parts. In such case, however, the rebuilder's records must show that (1) the used parts accepted are identified as relating to sales of specific rebuilt parts and (2) such used parts are like, both in kind and in number, the rebuilt parts for which they are accepted in exchange. On outright sales of rebuilt parts, the tax must be computed on the actual prices charged. However, subsequent to an outright sale, the rebuilder may accept like used parts from the customer and credit his account for the value thereof. In such case, the rebuilder may take a credit or file a claim for refund in the amount of tax paid upon the portion of the sale price which is readjusted in this manner except that, for purposes of this credit or refund, the rebuilder may not readjust the sale price by crediting the value of any number of used parts in excess of the number of like rebuilt parts sold outright to that particular customer.

PART III.—PETROLEUM PRODUCTS

SUBPART A.—GASOLINE

SECTION 4081.—IMPOSITION OF TAX

The Revenue Service discusses the acceptability of microfilm reproductions of records of companies liable for manufacturers excise taxes on gasoline and lubricating oil. See Rev. Rul. 56-260, page 555.

SUBPART B.—LUBRICATING OIL

SECTION 4091.—IMPOSITION OF TAX

Applicability of the exemption from manufacturers excise tax with respect to sales for export where varying grades of taxable lubricating oils are sold by the producer to a person who mixes them prior to exportation. See Rev. Rul. 56-257, page 511.

The Revenue Service discusses the acceptability of microfilm reproductions of records of companies liable for manufacturers excise tax on gasoline and lubricating oil. See Rev. Rul. 56-260, page 555.

SUBCHAPTER B.—HOUSEHOLD TYPE EQUIPMENT, ETC.

PART II.—ELECTRIC, GAS, AND OIL APPLIANCES

SECTION 4121.—IMPOSITION OF TAX

Rev. Rul. 56-276

The manufacturers excise tax on gas water heaters, imposed by section 4121(a) of the Internal Revenue Code of 1954, is limited in application to heaters of the household type. Revenue Ruling 55-645, C. B. 1955-2, 455, holds that a gas water heater having a gas input rating of less than 50,000 B. T. U. per hour is a heater of the household type, and the sale of such a heater by the manufacturer is subject to tax, unless the heater by reason of design and construction is primarily adapted for purposes other than household use. *Held*, a gas-fired heater primarily designed to furnish both heat and hot water for farm milk houses is not a heater of the household type as contemplated by section 4121(a) of the Code, even though its gas input rating is less than 50,000 B. T. U. per hour. Accordingly, the sale of such a combination heater by the manufacturer is not subject to the tax.

(Also Section 4218.) Rev. Rul. 56-283

Where the manufacturer of a taxable clothes dryer uses such article in the manufacture of a nontaxable washer-dryer combination, he is liable for manufacturers excise tax in the same manner as if the dryer were sold by him, even though certain parts are common to both the washer and the dryer.

Advice has been requested whether the manufacturers excise tax, imposed by section 4121 of the Internal Revenue Code of 1954, is applicable to a washer-dryer combination.

In the instant case, the washer-dryer combines the functions of a clothes washer and a clothes dryer. This type of appliance will wash, rinse, spin-dry and dry clothes in one continuous operation. Heaters maintain water temperature during the washing cycle and evaporate moisture during the drying cycle. During the drying cycle, the tub revolves at washing cycle speed, permitting the washed articles to tumble through heated air until dry. Physically, the appliance includes certain parts which perform a drying function, others which perform a washing function, and still others which serve a common purpose in both the washing and the drying operations. Consequently, because of its common parts which serve a dual function, the appliance cannot be broken down into two separately identifiable units, one functioning only as a washer and the other functioning only as a dryer.

Section 4121(a) of the Code imposes a tax on electric or gas clothes dryers of the household type when sold by the manufacturer, producer or importer. Section 4218(a) of the Code provides that if a manufacturer of a taxable article uses that article in the manufacture of a nontaxable article, he is liable for the tax on his use of the taxable article in the same manner as if it were sold by him. The tax is computed on the price at which such or similar articles are sold in the ordinary course of trade by manufacturers, producers, or importers thereof, as determined by the Secretary of the Treasury or his delegate.

In the manufacture of the washer-dryer combination, a completely separate dryer, as such, is not produced. Nevertheless, within the contemplation of the law, a dryer has been produced and incorporated into the appliance. Accordingly, it is held that the manufacturer is taxable under section 4218(a) of the Code on his use of the dryer in the manufacture of the nontaxable washer-dryer combination.

It is further held that the fair market price of the dryer on which the tax is to be based should be determined by applying to the lowest established wholesale price for the washer-dryer combination the ratio which the cost of the dryer parts bears to the cost of both the washer and dryer parts. The cost of the common parts is allocable to the washer and dryer parts in the same ratio and, therefore, may be disregarded since the inclusion and allocation of the cost of such common parts in the determination would result in the same ratio between the cost of the taxable dryer and the cost of the complete unit.

For example, suppose that the washer parts cost $21x$ dollars, the dryer parts cost $9x$ dollars, and the common parts cost $50x$ dollars. On this basis 30 percent (9/30ths) of the total cost of the combination represents the cost of the dryer. The fair market price of such dryer is determined by applying 30 percent to the lowest established wholesale price for the washer-dryer combination. The tax is then computed upon the fair market price so determined.

SUBCHAPTER C.—ENTERTAINMENT EQUIPMENT

PART I.—RADIO AND TELEVISION SETS, PHONOGRAPHS AND RECORDS

SECTION 4141.—IMPOSITION OF TAX

(Also Section 4142.) Rev. Rul. 56–255

Sales by the manufacturer of radio and television components named in section 4142 of the Internal Revenue Code of 1954 are taxable if they are suitable for use with any radio or television receiving set, phonograph, or combination enumerated in section 4141, without regard to whether such set, phonograph, or combination is of the entertainment type or of the nonentertainment type.

The Internal Revenue Service has been asked whether the manufacturers excise tax on radio and television components applies to components which are suitable for use only on commercial or nonentertainment type radio or television receiving sets.

Section 4141 of the Internal Revenue Code of 1954 imposes a tax upon sales by the manufacturer, producer, or importer of radio receiving sets, automobile radio receiving sets, television receiving sets, automobile television receiving sets, phonographs, combinations of any of the foregoing, radio and television components, and phonographs records. Effective September 1, 1955, that section was amended by Public Law 367, 84th Congress, 69 Stat. 689, C. B. 1955–2, 768, to provide that "Except in the case of radio and television components and phonograph records, the tax imposed by this section shall apply only to articles of the entertainment type."

The term "radio and television components" is defined in section 4142 of the Code as meaning chassis, cabinets, tubes, speakers, amplifiers, power supply units, antennae of the "built-in" type, and phonograph mechanisms, which are suitable for use on or in connection with, or as component parts of, any of the articles enumerated in section 4141, whether or not primarily adapted for such use.

Under the above provisions of law, it is held that sales by the manufacturer of radio and television components named in section 4142 of the Code are taxable if they are suitable for use with any radio or television receiving set, phonograph, or combination *enumerated* in section 4141, without regard to whether such set, phonograph, or combination is of the entertainment type or of the nonentertainment type, unless such sales are otherwise exempt as sales for further manufacture, for export, for the exclusive use of a State, etc.

SECTION 4142.—DEFINITION OF RADIO AND TELEVISION COMPONENT

Rev. Rul. 56–217

Germanium transistors, germanium point-contact photocells, and selenium, copper-oxide or similar rectifiers are not considered to be radio or television tubes of the types contemplated in section 4142 of the Internal Revenue Code of 1954. Therefore, such articles are not subject to manufacturers excise tax.

Rev. Rul. 56–228

Establishment of a voice coil impedance test for determining whether speakers are suitable for use with radio and television sets, or phonographs, and therefore are subject to the manufacturers excise tax imposed by section 4141 of the Internal Revenue Code of 1954.

Advice has been requested concerning the types of speakers which are subject to the manufacturers excise tax on radio and television components.

Section 4141 of the Internal Revenue Code of 1954 imposes a tax upon sales by the manufacturer, producer, or importer of radio receiving sets, automobile radio receiving sets, television receiving sets, automobile television receiving sets, phonographs, combinations of any of the foregoing, radio and television components, and phonograph records. Effective September 1, 1955, that section was amended

by Public Law 367, 84th Congress, 69 Stat. 689, C. B. 1955–2, 768, to provide that "Except in the case of radio and television components and phonograph records, the tax imposed by this section shall apply only to articles of the entertainment type."

The term "radio and television components" is defined in section 4142 of the Code as meaning chassis, cabinets, tubes, speakers, amplifiers, power supply units, antennae of the "built-in" type, and phonograph mechanisms, which are suitable for use on or in connection with, or as component parts of, any of the articles enumerated in section 4141, whether or not primarily adapted for such use.

It has been found that, under present standards set by the industry, voice coil impedance is a prime factor in determining whether speakers are suitable for use with radio and television receiving sets, phonographs, or combinations thereof. Substantially all speakers for such receiving sets and phonographs have been standardized with a voice coil impedance of 3.2 ohms. There are a few exceptions where speakers with voice coil impedances of 4, 5, and 6 ohms are used for this purpose. On the other hand, the public address field has standardized on speakers with voice coil impedances of 4, 8, and 16 ohms. Also, certain speakers with higher voice coil impedance ratings are specially adapted for other uses, such as intercommunication systems.

Accordingly, speakers with a voice coil impedance rating of 8 ohms or more are not considered suitable for use on or in connection with, or as component parts of, any of the articles enumerated in section 4141 of the Code unless they are recommended for such use by the manufacturer. Generally, speakers with a voice coil impedance rating of less than 8 ohms are considered taxable; however, a speaker which is so designed and constructed as to render it otherwise unsuitable for use with a radio or television set or phonograph is not taxable despite its voice coil impedance rating. In such case, the manufacturer may obtain a ruling from the Internal Revenue Service upon submission of a detailed description of his particular speaker.

Applicability of the tax on radio and television components which are suitable for use only on commercial or nonentertainment type radio or television receiving sets. See Rev. Rul. 56–255, page 508.

SUBCHAPTER D.—RECREATIONAL EQUIPMENT

PART III.—FIREARMS

SECTION 4181.—IMPOSITION OF TAX

Rev. Rul. 56–208

The tax imposed by section 4181 of the Internal Revenue Code of 1954 on the sale by the manufacturer (including producer or importer) of firearms, shells and cartridges attaches only to sales of complete firearms, including firearms sold in a knockdown condition. Where a manufacturer sells a complete firearm, the tax attaches with respect to the sale of such firearm. However, no tax attaches to the sale of extra

interchangeable parts such as shotgun barrels which may be sold by the manufacturer with the firearm, provided his records are sufficient to establish the price charged by him for the taxable firearm. As to parts or accessories sold for use as spare parts or accessories, see Rev. Rul. 54–98, C. B. 1954–1, 264.

Rev. Rul. 56–209

Application of the manufacturers excise tax to the reloading of used shells for pistols, revolvers, shotguns, and other firearms.

Advice has been requested regarding the application of the manufacturers excise tax to sales of reloaded shotgun shells.

Section 4181 of the Internal Revenue Code of 1954 imposes a tax on shells and cartridges when sold by the manufacturer thereof. The term "manufacturer" includes a person who produces a taxable article from scrap, salvage, or junk material, as well as from new or raw material, (1) by processing, manipulating, or changing the form of an article, or (2) by combining or assembling two or more articles.

It is held that the reloading of used shotgun shells is a manufacturing operation and the sale by the reloader of such shells is, therefore, subject to the excise tax. However, a different ruling applies in the case of custom reloading. Where the reloader merely reloads shells belonging to his customer and is paid for his labor and materials expended in performing such reloading service, there is not a taxable sale of reloaded shells as such. In the latter case, there must be a return to the customer of the identical shells tendered by the customer for reloading. If, instead of a return of the identical shells, an equivalent number is withdrawn from the inventory of the reloader, the transaction is regarded as a taxable sale of reloaded shells on an exchange basis and the person reloading the shells is liable for the tax.

SUBCHAPTER F.—SPECIAL PROVISIONS APPLICABLE TO MANUFACTURERS TAX

SECTION 4218.—USE BY MANUFACTURER OR IMPORTER CONSIDERED SALE

Use of a taxable clothes dryer in the manufacture of a nontaxable washer-dryer combination. See Rev. Rul. 56–283, page 507.

SECTION 4225.—EXEMPTION FOR EXPORTS

(Also Section 4091.) Rev. Rul. 56–257

The exemption from manufacturers excise tax with respect to sales for export, provided by section 4225 of the Internal Revenue Code of 1954, does not apply where varying grades of taxable lubricating oils are sold by the producer to a person who mixes them prior to exportation.

Advice has been requested whether the exemption from manufacturers excise tax, with respect to the sale of taxable lubricating oil for

export, applies where varying grades of taxable lubricating oils are sold by the producer to a person who mixes them prior to exportation.

Under provisions of section 4225 of the Internal Revenue Code of 1954, the manufacturers excise tax does not apply to the sale of an article for export or for shipment to a possession of the United States and, in due course, so exported or shipped.

Section 314.25 of Regulations 44, made applicable to the 1954 Code by Treasury Decision 6091, C. B. 1954–2, 47, provides, in part, that where delivery of an article sold by the manufacturer is to be made within the United States, the article will be regarded as having been sold for export if the manufacturer has in his possession a statement from the purchaser showing (1) that the article is purchased to fill an existing or future order for delivery to a foreign destination; or that the article is purchased for resale to another person who will export the article, and (2) that such article will be transported to its foreign destination in due course prior to *use* or *further manufacture* and prior to any resale except for export.

It is held that while the mixing of varying grades of taxable lubricating oils does not constitute "further manufacture" of such oils it does constitute a "use" of the oils prior to exportation within the meaning of the regulations. Accordingly, the exemption provided with respect to the sale of taxable lubricating oils for export does not apply where the taxable lubricating oils are sold by the producer to a person who mixes them prior to exportation.

CHAPTER 33.—FACILITIES AND SERVICES

SUBCHAPTER A.—ADMISSIONS AND DUES

PART I.—ADMISSIONS

SECTION 4231.—IMPOSITION OF TAX

Rev. Rul. 56–38

In an effort to induce patrons to attend evening shows, a number of downtown motion picture theatres of a large city have arranged with parking lot operators for a special evening parking rate of 25 cents per car for their patrons. Upon payment of the parking charge, the patron is given a receipt which, when presented to the cashier at a motion picture theatre, entitles him to credit for the amount so paid on the charge for admission to the theatre. A special ticket of admission is issued to such patrons. Only one such admission is granted for each car parked, and a higher charge must be paid by or for other persons, even those who are passengers in the same car. For example, where the established price for certain accommodations is 80 cents plus admissions tax, the patron who presents a receipt for 25 cents from a parking lot operator may obtain a special ticket for

55 cents plus admissions tax, which entitles him to the use of the same accommodations as the 80 cents ticket plus tax does. No part of the parking charges is received by the theatre operators. *Held*, the parking charge is not an amount paid for admission, as contemplated by section 4231 of the Internal Revenue Code of 1954. Accordingly, in the example given above, the admission price of 55 cents represents a special reduced rate for patrons of the parking lot, and the tax may properly be based thereon.

Rev. Rul. 56–39

The tax on admissions, imposed by section 4231 of the Internal Revenue Code of 1954, applies to an admission charge in excess of 50 cents even though the excess is only a fraction of a cent. However, where an admission charge is 50 cents and the computation of a state tax thereon results in a fractional part of a cent, which necessitates the collection of an amount in excess of the state tax actually due, the Federal tax on admissions does not apply provided such excess amount is shown as state tax. In such case, the excess amount collected is not considered to be an additional charge for admission.

(Also Part II, Section 1700; Regulation 43, Section 101.4.) Rev. Rul. 56–111

The applicability of the tax on admissions is to be determined by the total amount paid for admission to a place, including an amount paid for a reserved seat or a similar accommodation.

Advice has been requested whether the exclusion from admissions tax with respect to an admission charge of 50 cents or less is applicable where a person, who has paid a general admission charge of 50 cents to a place, pays an additional charge of 50 cents for a superior accommodation, such as a reserved seat.

Under the provisions of section 4231 of the Internal Revenue Code of 1954, except in the case of admissions to a horse or dog race track, the tax on admissions is not applicable if the amount paid for the admission is 50 cents or less. Section 4232 provides that the term "admission" includes seats and tables, reserved or otherwise, and other similar accommodations, and the charges made therefor.

Section 101.4 of Regulations 43, made applicable to the 1954 Code by Treasury Decision 6091, C. B. 1954–2, 47, provides that where, after paying one charge, a second charge is made for accommodations which are essentially an extension of the accommodations granted in return for the payment of the first charge, the tax attaches to the total of the two charges made.

It is held that where, under the circumstances described, a person pays a charge of 50 cents for a reserved seat or a similar accommodation in addition to a charge of 50 cents for general admission, the total of the charges paid, or one dollar, constitutes the amount paid for admission within the meaning of the law and regulations and, accordingly, is subject to tax.

(Also Sections 170, 4233.) Rev. Rul. 56–120

Amounts paid for admission to a motion picture exhibition as a part of a campaign to raise funds for an organization operated exclusively for charitable purposes are subject to the admissions tax, under section 4231 of the Internal Revenue Code of 1954, on that portion which represents a reasonable admission charge to the exhibition.

The amount of the payment which is in excess of a reasonable admission charge plus the admissions tax thereon may be considered a charitable contribution under section 170 of the Code.

Advice has been requested concerning the applicability of the tax on admissions, imposed by section 4231 of the Internal Revenue Code of 1954, and the deductibility as a charitable contribution, under section 170 of the Code, in cases where payment of an amount designated as a contribution entitles a person to admission to a motion picture exhibition.

In the instant case an organization operated exclusively for charitable purposes, exempt from income tax under section 501(a) as an organization described in section 501(c)(3) of the Code, presented a premier showing of a motion picture as a part of a campaign to raise funds. The entire operation connected with the showing of the motion picture, including the picture, theatre and staff, and the printing of tickets, was made available to the organization without charge. The prices for tickets sold in connection with the performance were $25, $10, and $5. The net proceeds from sale of the tickets inured exclusively to the benefit of the organization.

Section 4231 of the Code imposes a tax on the amount paid for admission to any place, including admission by season ticket or subscription.

Section 4233(a)(1)(A)(iii) of the Code provides in part for exemption from the tax imposed by section 4231 of the Code with respect to admissions all the proceeds of which inure to a corporation or any community chest, fund, or foundation organized and operated exclusively for charitable purposes, exempt under section 501(a) as an organization described in section 501(c)(3) of the Code, if such corporation or organization is primarily supported by contributions from the general public. However, under the provisions of section 4233(a)(1)(C)(iv) of the Code, the exemption provided by section 4233(a)(1)(A)(iii) of the Code does not apply in the case of admissions to any motion picture exhibition.

Section 170 of the Code provides for the deduction from gross income, in computing taxable income, of contributions or gifts payment of which is made within the taxable year to or for the use of such organizations therein specified.

The instant organization is the type of charitable organization contemplated by section 4233(a)(1)(A)(iii) of the Code but the specific exclusion from exemption contained in section 4233(a)(1)(C)(iv) precludes the exemption which would otherwise apply to an admission charge. However, where payment of an amount designated as a contribution entitles a person to admission to a place and the designated contribution is so large that it is obviously intended to be more

than a payment for admission, there is warrant for the recognition of a contribution within the payment.

Accordingly, it is held that the amount paid for admission to a motion picture exhibition, as a part of a campaign to raise funds for an organization operated exclusively for charitable purposes, is considered a charitable contribution, deductible under section 170 of the Code, to the extent that the amount exceeds the amount which would ordinarily be paid for admission to that motion picture, provided no other form of entertainment or refreshments are received. That part of the amount paid which is considered a contribution is not a charge for admission and, therefore, is not subject to the admissions tax. However, the amount which represents the admission charge is subject to the admissions tax since, under section 4233(a)(1)(C)(iv) of the Code, admissions to a motion picture exhibition are nonexempt regardless of the nature of the organization which conducts the affair or the disposition made of the proceeds. The breakdown of such payment is illustrated by the following example: If a $25 ticket entitles a person to seating accommodations for which the usual admission charge to a premier showing of a motion picture is $12.50, the amount of $12.50 would be subject to the ten percent admissions tax, and $11.25 ($25.00 minus $13.75, the admission charge plus tax) would be regarded as a contribution.

Revenue Ruling 112, C. B. 1953–1, 411, relating to a "donation" made in lieu of a payment of a fixed charge for admission to a motion picture, was based on circumstances which are not similar to those in the instant case, and is not affected by the holding in this case.

Rev. Rul. 56–167

Applicability of the cabaret tax, imposed by section 4231(6) of the Internal Revenue Code of 1954, to restaurants, taverns, and similar establishments where patrons engage in community singing.

Advice has been requested whether the cabaret tax applies to taverns, restaurants, and similar establishments where patrons engage in community singing.

The cabaret tax, imposed by section 4231(6) of the Internal Revenue Code of 1954, applies to all amounts paid for admission, refreshment, service, or merchandise, at any roof garden, cabaret, or other similar place furnishing a "public performance for profit," by or for any patron or guest who is entitled to be present during any portion of such performance.

It is held that spontaneous community singing by itself does not constitute a "public performance for profit" within the meaning of section 4231(6) of the Code. Therefore, restaurants, taverns, and similar establishments where patrons engage in community singing do not, by reason of such singing, incur liability for cabaret tax.

Some establishments contain what are known as "piano bars." A piano bar consists of a counter or bar built around a piano. This arrangement enables patrons to sit at the bar and still be near the instrument. Spontaneous community singing by patrons would not

of itself bring such an establishment within the purview of the cabaret tax.

It is not intended by the foregoing ruling to convey the idea generally that self-entertainment provided by patrons does not constitute a "public performance for profit" within the meaning of the law. Where the management does more than merely furnish physical surroundings conducive to community singing, the establishment will become subject to the tax. Thus, where the management employs a master of ceremonies or other person who joins in or conducts the community singing, or where the management provides song sheets or flashes on the walls the words of songs to be sung by the patrons, the management will be considered as furnishing a "public performance for profit."

Where the master of ceremonies carries a microphone about the establishment and selects from among the patrons and guests those who can provide entertainment to the others by personal interviews, telling jokes or stories, singing songs, etc., the entertainment so provided will likewise be regarded as a "public performance for profit" furnished by the proprietor.

The examples given above of both nontaxable and taxable entertainment are merely illustrative of the views of the Internal Revenue Service on this subject. They do not offer a definitive or comprehensive statement of principles applicable to all cases. The result in any case not coming squarely within the examples must be based solely on the facts involved in such case.

(Also Section 4233.) Rev. Rul. 56–175

Section 4233 of the Internal Revenue Code of 1954 provides certain exemptions from the admissions tax imposed by section 4231, including charges for admission to any athletic game between teams composed of students from elementary or secondary schools, or colleges, if the entire gross proceeds from such game inure to the benefit of a hospital for crippled children. *Held*, the routine dental examinations and treatments which are generally characteristic of a dental clinic do not qualify the clinic as a "hospital for crippled children." Accordingly, the charges for admission to an athletic game between teams composed of students from elementary or secondary schools, or colleges, which inure to the benefit of a dental clinic for children, are subject to the tax on admissions imposed by section 4231 of the Code.

SECTION 4233.—EXEMPTIONS

Rev. Rul. 56–40

Pursuant to the exemption provisions of section 4233(a)(1)(C) of the Internal Revenue Code of 1954, the tax on admissions does not apply in the case of any athletic event between educational institutions held during the regular athletic season for such event, if the proceeds therefrom inure exclusively to the benefit of such institutions.

Held, a playoff game or other athletic event between educational institutions, which is necessary to settle a conference, state, or sectional championship, is considered an event held during the regular season for the purpose of the exemption, and amounts paid for admissions thereto are not subject to tax, provided the proceeds therefrom inure exclusively to the benefit of the participating institutions. However, the tax on admissions applies to a postseason athletic game or exhibition, such as a "bowl" game, unless, as provided in section 4233(a)(1)(C), the proceeds therefrom inure exclusively to the benefit of an elementary or secondary school or unless, in the case of a game between teams composed of students from elementary or secondary schools, or colleges, the entire gross proceeds from such game inure to the benefit of a hospital for crippled children.

(Also Part II, Section 1701; Regulations 43, Section 101.15.) Rev. Rul. 56–190

A tour of homes and gardens noteworthy for their attractiveness and landscaping, conducted by an organization whose purpose is the promotion of interest in home and civic planting and roadside beautification, does not qualify as "part of a program conducted by a society or organization to permit the inspection of historical homes and gardens," as contemplated by section 4233(a)(5) of the Internal Revenue Code of 1954 (section 1701(e)(1) of the Internal Revenue Code of 1939).

Advice has been requested whether the exemption from admissions tax provided by section 4233(a)(5) of the Internal Revenue Code of 1954 (section 1701(e)(1) of the Internal Revenue Code of 1939) applies to charges for admission to the tour of homes and gardens described below.

An organization was formed for the purpose of making a more attractive community by promoting interest in home and civic planting and roadside beautification. Funds for the program are derived from charges for admission collected on an annually conducted tour of homes and gardens noteworthy for their attractiveness and landscaping. Of the fifty or more homes and gardens included in the tour, only one or two are considered to be historical. The expenses of the tour are paid by a local business institution which assists in the promotion of the tour as a civic duty. All of the receipts from admissions are used by the organization in its home and roadside beautification program.

Section 4233(a)(5) of the Code exempts from tax any admission to a home or garden which is temporarily opened to the general public as part of a program conducted by a society or organization to permit the inspection of historical homes and gardens, if no part of the net earnings thereof inures to the benefit of any private stockholder or individual.

This exemption is dependent upon the existence of a tour conducted by a "society or organization" as a part of a program the primary purpose of which is "to permit the inspection of historical homes and gardens." In this case, the purpose of the tour is to enable members of the public to inspect homes and gardens which are outstanding be-

cause of their attractiveness and landscaping. The fact that an occasional home or garden included in the tour may have some historical significance does not determine the purpose of the program of which the tour is a part.

Therefore, it is held that this tour of homes and gardens does not qualify for the exemption provided by section 4233(a)(5) of the Code. Accordingly, charges for admission are subject to the tax imposed by section 4231 of the Code.

Method of determining the amount considered to be an admission charge which is nonexempt under the provisions of section 4233(a)(1)(C)(iv) of the Internal Revenue Code of 1954 where admission to a motion picture is gained by making a specified contribution to a charitable fund. See Rev. Rul. 56-120, page 514.

Qualification of dental clinic as hospital for crippled children. See Rev. Rul. 56-175, page 516.

SUBCHAPTER B.—COMMUNICATIONS

SECTION 4251.—IMPOSITION OF TAX

REGULATIONS 42, SECTION 130.41: Rate and application of tax. Rev. Rul. 56-248

> Assessments or charges paid by members or subscribers of a mutual or cooperative telephone company, association, or system, for switching services or facilities, or for the repair or replacement of instruments, poles, wires, equipment, etc., incidental to ordinary maintenance, are subject to the tax for local telephone service under section 4251 of the Internal Revenue Code of 1954.

Advice has been requested concerning the applicability of the tax on local telephone service, imposed by section 4251 of the Internal Revenue Code of 1954, to assessments or charges against members or subscribers of a mutual or cooperative telephone company or association for switching services or facilities, or for the repair or replacement of instruments, poles, wires, equipment, etc., incidental to ordinary maintenance.

Semiannually, a mutual or cooperative telephone company makes assessments against its members or subscribers for maintenance and repair of the members' telephone instruments and lines. The cooperative does not own a switchboard. Consequently, all switching is done by a commercial communication carrier. Charges for this latter service, together with the applicable tax, are billed directly to the subscribers or members on a monthly rate basis by the commercial carrier. In another situation, the mutual or cooperative telephone company collects assessments from its members which include a proportionate amount which the cooperative pays to a commercial communication carrier for switching service. The difference between the amount assessed against the members and the amount paid to the carrier is retained by the cooperative for maintenance and repair purposes. In

a third situation, as a result of recent storms, a mutual telephone company suffered severe damage to its lines. It was necessary to purchase poles, wire, and other miscellaneous equipment, to repair the damage. To cover this cost of repairs, an assessment was made by the company against its subscribers.

Section 4251 of the Internal Revenue Code of 1954 provides that a tax shall be imposed on the amount paid for local telephone service and that the tax shall be paid by the person paying for the service or facilities.

Section 4252(a) of the Code provides that the term "local telephone service" means any telephone service not taxable as long distance telephone service; leased wire, teletypewriter or talking circuit special service; or wire and equipment service. Amounts paid for the installation of instruments, wires, poles, switchboards, apparatus, and equipment, shall not be considered amounts paid for service. It is the position of the Internal Revenue Service that this latter sentence applies specifically to amounts paid for initial installations, installations in expansion of existing facilities, installations necessary to provide an entirely different service from that being provided, or installations necessary to the conversion of a telephone system.

Section 4291 of the Code provides that every person, receiving any payment for service or facilities on which a tax is imposed upon the payor thereof, shall collect the tax from the person making such payment.

Section 130.41 of Regulations 42, which is made applicable to the Internal Revenue Code of 1954 by Treasury Decision 6091, C. B. 1954–2, 47, provides that the "amount paid" means the amount collected for the service whether the charge is made on a monthly or other periodic basis, or is based on the number of calls made, or is in the form of an assessment as in the case of a mutual telephone system.

Recurring damage to and the progressive deterioration of the plant of a telephone system are normally accepted factors in the operation and maintenance of such system. The repair and replacement of components such as lines, poles, etc., as a result of such deterioration or as a result of storms, are incidental to ordinary maintenance. This would be true regardless of whether it is the system of a commercial carrier or a mutual or cooperative association.

Commercial communications carriers, in fixing rates, provide reserves for the repair and replacement of plant components such as instruments, poles, wires, equipment, etc. Mutual or cooperative companies follow the same practice, or make proportionate assessments to cover the repair and replacement of components as the need arises.

Accordingly, it is held that assessments or charges paid by members or subscribers of a mutual or cooperative telephone company, association, or system, for the repair or replacement of instruments, poles, wires, equipment, etc., incidental to ordinary maintenance, are subject to the tax for local telephone service under section 4251 of the Code. The tax also applies to assessments or charges paid by such members or subscribers to cover charges for switching services or facilities, whether fixed on a pro rata or other basis. Such tax should be collected by the mutual or cooperative company, or by the entity furnishing the switching services or facilities, whichever is the agency receiving direct payment from the individual members or subscribers.

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SECTION 4253.—EXEMPTIONS

(Also Part II, Section 3465; Regulations 42, Section 130.38.) Rev. Rul. 56–90

The closed-circuit television transmission of events or activities for private screening for limited audiences does not constitute the conduct of the business of a "broadcasting station or network" within the meaning of section 4253(f) of the Internal Revenue Code of 1954; therefore, amounts paid to a telephone company for the lease of wires and equipment utilized for that purpose are not exempt by that section from the tax on communications imposed by section 4251 of the Code.

Advice has been requested whether a closed-circuit television transmission of events or activities to limited outlets and audiences, and not to the general public, constitutes the conduct of the business of a "broadcasting station or network" within the meaning of section 4253(f) of the Internal Revenue Code of 1954, so as to exempt from the tax on communications the amounts paid to a telephone company for the lease of wires and equipment utilized in connection with such transmission.

Through the use of closed-circuit television transmission facilities, a company provides for the private screening for limited audiences of special events or activities, such as business conferences, speeches, lectures, etc. This service is adaptable for use by private businesses, industrial organizations, professional associations and similar groups. The lines used for the transmission of these programs are leased from a telephone company.

Section 4251 of the Code imposes a tax on the amount paid for certain communication services or facilities, including the type utilized here.

Section 4253(f) of the Code provides that no tax shall be imposed on the amount paid for so much of leased wire, teletypewriter or talking circuit special service, or wire and equipment service, as is utilized in the conduct, by a common carrier or a telephone or telegraph company or a radio broadcasting station or network, of its business as such.

Although that section does not specifically mention a "television" broadcasting station or network among those public service activities which may qualify for exemption, the term "radio broadcasting station or network" is construed to include a company engaged in the transmission of video as well as audio signals. However, in limiting the exemption to amounts paid for service utilized by a broadcasting station or network in the conduct of its business *as such*, it is considered that Congress intended to exempt only amounts paid for the designated taxable communicatons services utilized in the business of furnishing programs to the general public.

Accordingly, it is held that, since closed-circuit television transmission is not intended to be received by the general public but is directed through controlled outlets to limited audiences, it does not come within the scope of the business of a "broadcasting station or network" within the intent and meaning of section 4253(f) of the Code. Therefore, amounts paid to a telephone company for the lease of wires and equipment utilized in connection with such transmission are not exempt by that section from the tax on communications imposed by section 4251 of the Code.

SUBCHAPTER C.—TRANSPORTATION

PART I.—PERSONS

SECTION 4261.—IMPOSITION OF TAX

Rev. Rul. 56–45

A baseball association leases a bus from a transportation company for the purpose of transporting the members of its team to the various towns where they are scheduled to play. The association employs the bus driver and carries liability and property damage insurance. No charge is made to the players for their transportation. *Held*, an amount paid for the rental or lease of a bus where the lessor does not furnish the driver and the bus is operated by the lessee or an employee of the lessee does not constitute an amount paid for transportation of persons within the meaning of section 4261 (a) of the Internal Revenue Code of 1954. In the instant case, since the amount paid by the association to the transportation company is not an amount paid for the transportation of persons, and since no charge is made by the association to the persons transported in the bus, no liability for tax on the transportation of persons is incurred.

Rev. Rul. 56–61

Transportation furnished regularly by a carrier between a resort hotel and a mountain summit constitutes the operation of motor vehicles on an established line and is taxable under section 4261 of the Internal Revenue Code of 1954, including the transportation of passengers who are occasionally picked up and delivered at places other than the terminal or the starting point. However, transportation to and from railroad stations furnished occasionally to hotel guests and transportation furnished only at infrequent intervals and without any degree of regularity to mountain climbers, skiers, sight-seeing parties, etc., whose pick-up and delivery points are designated by the passengers, does not constitute transportation on an established line and is, therefore, not subject to such tax.

Advice has been requested concerning the application of tax on the transportation of persons, imposed by section 4261 of the Internal Revenue Code of 1954, to charges made by a carrier which provides transportation service in a resort area.

A company, which operates station wagons having a seating capacity of eight passengers, including the driver, furnishes transportation services at a resort area between a certain hotel, which serves as its base of operation, and a mountain summit. It advertises and maintains regular service over this route and charges a fixed rate for a round trip which entitles passengers to transportation in a certain vehicle on a stated date. Occasionally, it picks up passengers for this trip in response to telephone calls at various resort points or surrounding towns for which no set charges are made other than the regular fee for transportation to the mountain summit. Under a working agreement with a hotel, it infrequently furnishes transporta-

tion to and from railroad stations for guests of the hotel for which no fixed charges are made by the carrier for a particular trip. It also furnishes transportation occasionally, within a radius of 25 miles, to mountain climbers, skiers, sightseeing parties, etc., whose pick-up and delivery points are designated by the passengers. There is no set fee for this service and the amount charged depends upon the circumstances involved.

Section 4261(a) of the Code imposes a tax upon amounts paid for the transportation of persons by rail, motor vehicle, water, or air. Section 4262(c) of the Code provides that the tax imposed by section 4261(a) of the Code shall not apply to transportation by motor vehicles having a passenger seating capacity of less than ten adult passengers, including the driver, except when such vehicle is operated on an established line.

Section 130.58 of Regulations 42, applicable under the 1954 Code by virtue of Treasury Decision 6091, C. B. 1954–2, 47, provides that the term "operated on an established line" means operated with some degree of regularity between definite points. It does not necessarily mean that strict regularity of schedule is maintained, that the full run is always made, that a particular route is followed, or that intermediate stops are restricted. The term implies that the person rendering the service maintains and exercises control over the direction, route, time, number of passengers carried, etc. It implies also that the primary contract between the operator and the person served is for the transportation of the person and not for the hire or use of the vehicle.

Accordingly, since the transportation provided by the carrier between the resort hotel and the mountain summit is operated with a sufficient degree of regularity between definite points and under such control of the carrier as to constitute the operation of motor vehicles on an established line, it is held that the tax on the transportation of persons imposed by section 4261 of the Code is applicable even though, in a few instances, the passengers are picked up and delivered at places other than the terminal or the starting point. Where transportation of guests of the hotel to and from railroad stations is furnished only at infrequent intervals and without any degree of regularity, and where transportation is furnished to mountain climbers, skiers, sightseeing parties, etc., whose pick-up and delivery points are designated entirely by the passengers, such transportation does not constitute the operation of motor vehicles on an established line within the meaning of section 4262(c) of the Code and, therefore, the charges for such transportation are not subject to the tax imposed by section 4261 of the Code.

Rev. Rul. 56–91

The tax on the transportation of persons, imposed by section 4261 of the Internal Revenue Code of 1954, which has been properly collected on the amount paid for a ticket for transportation may not be refunded, in case of the nonuse of the ticket, unless the amount paid for the transportation service is also refunded.

Certain carriers have included in their tariffs a restriction which, in case of the nonuse of tickets for transportation and for seating or

sleeping accommodations, prohibits refund of amounts paid therefor unless such tickets are cancelled within the period prescribed by the tariff. Advice has been requested whether the transportation tax collected on payments for the unused tickets may be refunded where the carrier refuses to refund the charges for the transportation service.

Section 4261(a) of the Internal Revenue Code of 1954 imposes a tax upon the amount paid within the United States for the transportation of persons by rail, motor vehicle, water, or air. Section 4261(c) of the Code imposes a tax upon the amount paid for seating or sleeping accommodations in connection with such transportation. Section 4261(d) provides that the tax on transportation of persons shall be paid by the person making the payment subject to the tax. Section 6415(d) provides in part that any person making a refund of any payment on which the tax on transportation of persons has been collected may repay therewith the amount of tax collected on such payment.

The tax on transportation of persons applies to the payment for the transportation and not to the actual transportation itself. Therefore, the tax attaches at the time the payment is made. The fact that the transportation takes place at a later date or never takes place does not affect the taxability of the payment.

Accordingly, it is held that, in case of the nonuse of a ticket for transportation or for seating or sleeping accommodations, the transportation tax properly collected thereon may not be refunded unless the carrier also refunds the payment for the transportation service.

Rev. Rul. 56–157

Many travel agencies and transportation companies are now selling travel gift certificates. While these certificates sometimes are issued in the precise amount of the fare for the journey which the donor wishes the donee to take, they frequently are issued in round-dollar amounts, generally in excess of the cost of the transportation contemplated by the purchaser. The recipient of the gift certificate has the right either to use the certificate for the purchase of transportation (receiving in cash any excess in value of the certificate over the cost of the transportation) or to take the entire face value of the certificate in cash without the purchase of any transportation. *Held*, since the gift certificates are nothing more than obligations accepted by the issuing agency or carrier to pay a sum certain in money to the designated payee upon demand, the amount paid for the purchase of such a gift certificate is not an amount paid for transportation within the meaning of section 4261 of the Internal Revenue Code of 1954. Therefore, the tax on transportation of persons does not apply to the purchase of the gift certificate. The payment for transportation takes place when the gift certificate is used by the donee for the purchase of transportation rather than when the gift certificate is purchased by the donor. Accordingly, at the time of such use any tax which may be due on the transportation purchased should be collected.

PART II.—PROPERTY

SECTION 4271.—IMPOSITION OF TAX

(Also Part II, Section 3475; Regulations 113, Section 143.1.) Rev. Rul. 56-16

Applicability of the tax on the transportation of property, imposed by section 4271 of the Internal Revenue Code of 1954, to charges made by a carrier to a customer, pursuant to an average demurrage agreement, for demurrage on cars of coal and other commodities.

Advice has been requested concerning the application of the tax on the transportation of property, imposed by section 4271 of the Internal Revenue Code of 1954, to charges made by a carrier to a customer, pursuant to an average demurrage agreement, for demurrage on cars of coal and other commodities.

Under the average demurrage agreement, the customer is debited for the time cars are held for loading and unloading beyond a certain period and credited for the time cars are released by him within a certain period, demurrage charges being assessed by the carrier, usually at the end of the month, for any outstanding debits.

Section 4271(a) of the Code imposes a tax of three percent upon the amount paid within or without the United States for the transportation of property, except coal, by rail, motor vehicle, water, or air from one point in the United States to another. Section 4271(b) imposes upon the amount paid within or without the United States for the transportation of coal by rail, motor vehicle, water, or air from one point in the United States to another, a tax of four cents per short ton for coal so transported. Section 4272(c) exempts from tax the charges for transportation of coal with respect to which there has been a previous taxable transportation.

Section 143.1(d) of Regulations 113, made applicable to the Internal Revenue Code of 1954 by Treasury Decision 6091, C. B. 1954-2, 47, defines the term "transportation" to mean the movement of property by a person engaged in the business of transporting property for hire. In general, it includes accessorial services furnished in connection with a transportation movement, such as loading, unloading, demurrage, and similar services and facilities.

Pursuant to the provisions of the regulations, the three percent tax applies to amounts paid for demurrage incurred in connection with the transportation movement of property, other than coal, where the transportation charges are subject to tax. Amounts paid as demurrage charges in connection with the transportation of coal are not taxable since the tax is imposed at the rate of four cents per short ton and therefore is measured by the quantity of coal transported and not by the amount paid for the transportation or accessorial services in connection therewith.

Therefore, the carrier, for the purpose of computing the transportation tax on demurrage charges incurred by a customer, pursuant to an average demurrage agreement, should eliminate from its demurrage account with the customer all items, both debits and credits, applicable to cars of coal and compute the three percent tax on any remaining debit balance which results from taxable transportation movements.

Rev. Rul. 56–57

Method of determining the amount of tax on transportation of property which should be collected under section 4271(c) of the Internal Revenue Code of 1954, with respect to payments made within the United States for transportation of import shipments from adjacent foreign countries to points within the United States, where such shipments move on through rates.

Advice has been requested as to the method to be used by carriers in determining the amount of tax on the transportation of property which should be collected with respect to payments made within the United States for transportation of import shipments from adjacent foreign countries to points within the United States, where such shipments move on through rates.

Section 4271(c) of the Internal Revenue Code of 1954 provides that in the case of property transported from a point without the United States to a point within the United States, the tax shall apply to the amount paid within the United States for that part of the transportation which takes place within the United States. Section 143.13 of Regulations 113, made applicable to the Code of 1954 by Treasury Decision 6091, C. B. 1954–2, 47, provides that where the amount paid in the United States covers the entire movement of property from a point of origin in a foreign country to an inland point in the United States, the tax will apply to the pro rata part of such payment which represents transportation within the United States.

When import shipments from adjacent foreign countries move on through rates and there are no established divisions, it is held that the tax should be collected on that proportion of the total amount paid which the mileage within the United States bears to the mileage of the entire movement. Where there are established divisions based on the border, the tax should be collected on the portion of the through rate accruing from the border to the destination within the United States. Where established divisions are based upon a point not on the border, the tax should be collected on the portion of the through rate accruing from the basing point nearest the border to destination, plus or minus an amount computed upon the mileage from the basing point to the border.

(Also Part II, Section 3475, Regulations 113, Section 143.1.) Rev. Rul. 56–62

The tax on transportation of property imposed by section 4271 of the Internal Revenue Code of 1954 attaches to amounts paid to a carrier for the service of furnishing and installing grain doors or doorway barricades on box cars when such service is furnished in connection with the transportation of grain. However, the tax does not attach to amounts paid to a carrier for the rental of grain doors or lumber for the barricades where such doors or barricades are not installed by the carrier.

Advice has been requested concerning the applicability of the tax on transportation of property imposed by section 4271 of the Internal Revenue Code of 1954 to amounts paid to a carrier in connection with grain doors or doorway barricades installed on box cars used for the transportation of grain.

A shipper transports grain products in bulk in box cars which require doors or doorway barricades for protection of the grain. The expense of furnishing the doors or barricades must be borne by the shipper. He may contract with the carrier to install doors or doorway barricades on the box cars, or he may obtain the doors or the necessary lumber for the doorway barricades from the carrier on a rental basis and install such doors or barricades at his own expense.

Under the provisions of section 143.1(d) of Regulations 113 made applicable to the Internal Revenue Code of 1954 by Treasury Decision 6091, C. B. 1954–2, 47, the term "transportation," in general, includes accessorial services furnished in connection with a transportation movement, such as loading, unloading, handling, and similar services and facilities.

It is held that the service of furnishing and installing grain doors or barricading the doorways of box cars by a carrier in connection with the transportation of grain is accessorial to the transportation movement, and charges paid by the shipper for such services are subject to the tax on transportation of property. However, where the shipper merely rents from the carrier the grain doors or the lumber for use in barricading the doorways and installs the doors or barricades at his own expense, the rental charge is not a charge for an accessorial service and is not subject to the tax.

Rev. Rul. 56–112

The tax on the transportation of property applies to amounts paid to a trucking company by oil drilling concerns for hauling water to their oil rigs.

Advice has been requested whether amounts paid to a trucking company under the following circumstances are subject to tax on the transportation of property imposed by section 4271 of the Internal Revenue Code of 1954.

The trucking company hauls water to oil rigs of various oil drilling concerns. The water hauled is not purchased by the trucking company but is obtained by pumping it from streams. The oil drilling concerns pay the trucking company a fee based upon the number of barrels of water hauled or on an hourly basis. The concerns contend that they are purchasing water rather than paying for a transportation service.

The tax imposed by section 4271 of the Code applies to amounts paid for the transportation of property to a person engaged in the business of transporting property for hire. Section 143.1 of Regulations 113, made applicable to the 1954 Code by Treasury Decision 6091, C. B. 1954–2, 47, states that such a person includes a common carrier, contract carrier, or other person transporting property for hire wholly or in part by rail, motor vehicle, water or air. That section further states that the term "property" means any physical matter regardless of value over which the right of ownership or control may be exercised.

Under the circumstances described, the Internal Revenue Service would not regard the trucking company as a person engaged in the business of selling water. On the contrary, the facts indicate that the company does not perform any service from which it could gain a profit except the service of transportation. Accordingly, the amounts paid to the trucking company by the oil drilling concerns constitute

amounts paid for the transportation of the water and are subject to tax on the transportation of property. See Rev. Rul. 55–421, C. B. 1955–1, 539.

(Also Part II, Section 3475.) Rev. Rul. 56–218

Applicability of the transportation of property tax to amounts received by a truck owner for the "back-haul" of commodities, where his remuneration consists solely of a charge for the transportation.

The Internal Revenue Service has been asked whether, in accordance with the principle set forth in Revenue Ruling 55–421, C. B. 1955–1, 539, certain amounts received by truck owners for the "back-haul" of commodities under the circumstances described below are subject to the tax on the transportation of property imposed by section 4271 of the Internal Revenue Code of 1954.

Certain truck owners, such as farmers, grain and feed dealers, and stock and produce dealers, haul their products or wares from their homes or places of business to market in their trucks. In order to avoid returning with empty trucks, they enter into arrangements with companies located near their homes or places of business to keep such companies supplied with particular commodities which are available near the truck owners' market. Under the arrangement, the truck owners purchase the commodities and, upon delivery thereof to the companies' premises, receive 50 cents per hundredweight above the price for which purchased. If the purchase price to the truck owners is increased or decreased, the price to the companies is adjusted so as to maintain the 50 cents per hundredweight spread. The truck owners do not assume any risk of possible loss by reason of fluctuations in the prices of the commodities purchased, nor do they perform any service for the companies from which they could derive a profit except the service of transportation.

The main difference between the above facts and those involved in Revenue Ruling 55–421 is that in the instant case the individual truck owners obtain the orders for the commodities which they purchase, transport and sell to companies located near their homes or places of business, whereas in Revenue Ruling 55–421 the orders for the commodities transported were obtained by salesmen of such commodities who made arrangements with various truck owners to purchase, transport and sell the commodities to the salesmen's customers.

Revenue Ruling 55–421 sets forth the principle that, in general, where the delivery activities of a wholesale or retail merchant are carried on with his own trucks and are merely incidental to his business of selling merchandise, the merchant is not regarded as a person engaged in the business of transporting property for hire even though a separate charge for the delivery is made to the customer. However, where the truck owner does not have the usual indices of a merchant except the ownership of the commodities carried, and where his sole remuneration is based on a charge for transportation, the truck owner is considered to be engaged in the business of transporting property for hire.

It is held, in accordance with the principle set forth above, that the amounts paid to the truck owners by the companies in excess of the purchase price of the commodities paid by the truck owners constitute amounts paid by the companies for transportation to persons engaged

in the business of transporting property for hire within the meaning of the statute and are subject to tax. The truck owners should collect the tax at the time the transportation charges are paid to them.

(Also Part II, Section 3475; Regulations 113, Section 143.31.) Rev. Rul. 56–229

For purposes of the tax on the transportation of property, the stoppage of an export shipment of grain solely for the purpose of having it inspected to determine its grade and classification under official grain standards does not constitute a "break" in the continuity of the movement of the grain and, therefore, does not affect the exempt character of the export shipment. Section 143.31 of Regulations 113, made applicable to the Internal Revenue Code of 1954 by Treasury Decision 6091, C. B. 1954–2, 47, provides that a "break" may be said to occur wherever the property is stopped for a business purpose, such as grading, cleaning, mixing, sorting, or manufacturing, and not merely in accommodation to the means of transportation. The term "grading" used in the regulations, when applied to shipments of grain, has reference to the mixing of different shipments of grain for the purpose of obtaining a new grade and not to the inspection of the grain by Federal licensees or officials of the Department of Agriculture for the purpose of ascertaining the grade and classification of the shipment.

Rev. Rul. 56–258

The tax on the transportation of property, imposed by section 4271 of the Internal Revenue Code of 1954, applies to amounts billed by a carrier to a shipper or consignee to cover charges for bridge and tunnel tolls and ferry charges paid by the carrier, even though they may be billed separately.

Advice has been requested whether the tax on the transportation of property applies to amounts billed separately by a carrier to a shipper or consignee to cover bridge and tunnel tolls and ferry charges paid by the carrier in connection with a taxable transportation movement.

Section 4271 of the Internal Revenue Code of 1954 imposes a tax upon the amount paid for the transportation of property by rail, motor vehicle, water, or air, from one point in the United States to another. The tax is payable by the person making the taxable transportation payment and is collectible by the person receiving such payment.

Section 143.1 of Regulations 113, made applicable to the 1954 Code by Treasury Decision 6091, C. B. 1954–2, 47, defines the term "transportation" as the movement of property by a person engaged in the business of transporting property for hire, including interstate, intrastate, and intracity or other local movements, as well as towing, ferrying, switching, etc. However, under the provisions of section 143.13 of such regulations, the tax does not apply to an amount paid by a carrier, a freight forwarder, express company, or similar person for transportation with respect to which the tax is payable to such person.

M. T. 26, C. B. 1948–1, 141, holds that transportation of vehicles by ferry constitutes transportation by water within the meaning of the statute and that amounts paid to the operator of a ferry for the transportation of vehicles are subject to tax. M. T. 26 further holds,

however, that amounts paid by a carrier for the transportation of vehicles by ferry are not subject to the tax when such transportation service is part of a continuous transportation movement with respect to which tax has been paid by the shipper or is payable by the consignee at destination. It is to be noted that the reason ferry charges paid by a carrier under such circumstances are not taxable is that such charges are reflected in the total transportation charges upon which the carrier collects the tax from the shipper or consignee. The Internal Revenue Service has consistently held that amounts billed by a carrier to a shipper or consignee to cover ferry charges incurred by the carrier are properly subject to tax, whether billed separately by the carrier or included in his total transportation charge.

It is held that amounts billed by a carrier to a shipper or consignee to cover charges incurred by the carrier as part of his costs of operation, including bridge and tunnel tolls as well as ferry charges, constitute a part of the total transportation charges and are subject to tax even though they may be billed separately by the carrier.

Earlier unpublished rulings of the Service relating to charges for bridge and tunnel tolls have not been consistent with the position set forth herein; therefore, under the authority contained in section 7805(b) of the 1954 Code, this ruling, insofar as it relates to bridge and tunnel tolls, will be applied without retroactive effect as to payments made prior to July 1, 1956, except that any tax that has been paid on such payments will not be refunded.

Payments for towing automobiles where such towing is performed pursuant to a contract with a city or county and under orders of the police department. See Rev. Rul. 56–294, below.

SUBCHAPTER E.—SPECIAL PROVISIONS APPLICABLE TO SERVICES AND FACILITIES TAXES

SECTION 4292.—STATE AND LOCAL GOVERNMENTAL EXEMPTION

(Also Section 4271.) Rev. Rul. 56–294

> •Payments for the towing of automobiles, where such towing is performed pursuant to a contract with a city or county and under orders of the police department, constitute payments for transportation of property to or from a State or political subdivision thereof, within the meaning of section 4292 of the Internal Revenue Code of 1954, and, therefore, are exempt from the tax on transportation of property.

In Revenue Ruling 55–753, C. B. 1955–2, 468, it is held that where a person operating a sales agency, repair shop, or service station tows disabled automobiles on which he does not make the necessary repairs, he is to the extent of such towing a person engaged in the business of transporting property for hire, and the tax applies to the charges made for such towing.

The Internal Revenue Service has now been asked whether payments for towing automobiles when the towing is performed, pursuant

to a contract with a city or county, under orders of the police department are subject to the tax on transportation of property, or whether such payments are considered payments for transportation to or from a State or political subdivision thereof, and therefore are exempt from tax. The towing contracts include towing automobiles illegally parked or abandoned, those involved in accidents and impounded for safekeeping, and those parked on streets from which snow is to be removed. The towing charges are paid by the owners of the automobiles.

Section 4292 of the Internal Revenue Code of 1954 provides, in part, that no tax shall be imposed on amounts paid for the transportation of property to or from the Government of any State, Territory of the United States, or any political subdivision of the foregoing, or the District of Columbia.

It is held that the towing of automobiles when performed pursuant to a contract with a city or county and under orders of the police department constitutes transportation to or from a political subdivision of a State within the meaning of section 4292 of the Code. Under such circumstances, the fact that no repairs are made on the automobile by the person who tows it, or that its owner pays the towing charge, has no bearing on the case. Accordingly, payments for such towing are exempt from the tax on transportation of property.

Amounts paid for the transportation of property to or from the Indiana Toll Road Commission. See Rev. Rul. 56–33, page 62.

CHAPTER 34.—DOCUMENTARY STAMP TAXES

SUBCHAPTER D.—POLICIES ISSUED BY FOREIGN INSURERS

SECTION 4371.—IMPOSITION OF TAX

Rev. Rul. 56–259

The documentary stamp tax imposed by section 4371(1) of the Internal Revenue Code of 1954 applies to each policy of insurance issued by any foreign insurer to or for, or in the name of, a State, including political subdivisions and instrumentalities thereof. If such policies are purchased in the exercise of an essential governmental function, the State is not liable for the tax but the insurer or its agent, as one of the other parties to the transaction, is liable for the tax under the dual liability provisions of section 4383 of the Code.

Advice has been requested relative to the applicability of the documentary stamp tax to insurance policies purchased from foreign insurers by instrumentalities of a State.

For example, insurance policies were purchased from foreign insurance companies for and on behalf of a State by (1) an unincorporated State toll bridge authority insuring bridge property against loss or damage and (2) a school district insuring its schools against vandalism. Since the policies were issued on behalf of the State, the question arises as to whether a State is a "domestic corporation" within

the meaning of section 4372(d)(1) of the Internal Revenue Code of 1954. If the transactions are subject to tax, there is the further question of whether the State is immune from the tax.

Section 4371(1) of the Code imposes a tax on each policy of insurance issued by any foreign insurer to or for, or in the name of, an insured as defined in section 4372(d) of the Code. Section 4372(d) provides that, for the purpose of section 4371(1), the term "insured" means "(1) a domestic corporation or partnership, or an individual resident of the United States, against, or with respect to, hazards, risks, losses, or liabilities wholly or partly within the United States, * * *."

Section 4383 of the Code provides that the documentary stamp tax shall be paid by any of the parties to a taxable transaction, or by any person for whose use or benefit the transaction is made. The United States or any agency or instrumentality thereof shall not be liable for the tax with respect to an instrument to which it is a party, and affixing of stamps thereby shal not be deemed payment for the tax, which may be collected by assessment from any other party liable therefor.

In *United States* v. *Cooper Corporation*, 312 U. S. 600, it is stated that the purpose, the subject matter, the context, the legislative history, and the executive interpretation of a statute are aids to construction which may indicate an intent to bring state or nation within the scope of the law. In *Cotton* v. *United States*, 11 How. 229, the Supreme Court of the United States stated that "Every sovereign State is of necessity a body politic, or artificial person, and as such capable of making contracts and holding property * * *." In *Helvering* v. *Stockholms Enskilda Bank*, 293 U. S. 84, Ct. D. 887, C. B. XIII-2, 299 (1934), after having cited Blackstone to the effect that a sovereign is a corporation, the Court said: "This may be in the nature of a legal fiction; but legal fictions have an appropriate place in the administration of the law when they are required by the demands of convenience and justice." In view of the foregoing, a State is considered to be a "domestic corporation" for purposes of section 4372(d) of the Code.

The principle relating to the liability for documentary stamp tax on conveyances of realty sold to or by a State, or a political subdivision or corporate instrumentality thereof, set forth in M. T. 39, C. B. 1950-1, 141, is also applicable to the documentary stamp tax on foreign insurance policies. M. T. 39 holds that conveyance of real property to or by a State, or a political subdivision or corporate instrumentality thereof, are not exempt from the documentary stamp tax merely by reason of the governmental character of one of the parties to the transaction. Likewise, foreign insurance policies are not exempt from the documentary stamp tax merely by reason of the governmental character of one of the parties to the transaction.

It is considered, however, that a State, a political subdivision or an instrumentality thereof, is immune from liability under section 4383 of the Code for the documentary stamp tax imposed by section 4371(1) where, in its truly governmental capacity, it acquires insurance policies from foreign insurers with respect to hazards, risks, losses or liabilities wholy or partly within the United States. When a State, a political subdivision or instrumentality thereof enters into such a transaction, it is presumed that it does so in the course of perform-

ing an essential governmental function. In the examples given above, relating to policies insuring state properties against loss or damage, there are no facts which would overcome this presumption.

Accordingly, it is held that the documentary stamp tax imposed by section 4371(1) of the Code applies to each policy of insurance issued by any foreign insurer to or for, or in the name of, a State, including its political subdivisions and instrumentalities. It is held further that, if such policies are purchased in the exercise of an essential governmental function, the State is not liable for the tax, but the nonexempt party, the insurer or its agent, as one of the other parties to the transaction, is liable for the tax under the dual liability provisions of section 4383 of the Code.

CHAPTER 35.—TAXES ON WAGERING

SUBCHAPTER A.—TAX ON WAGERS

SECTION 4401.—IMPOSITION OF TAX

(Also Section 4411.) Rev. Rul. 56-72

Applicability of the taxes on wagering, imposed by sections 4401 and 4411 of the Internal Revenue Code of 1954, to the operation of a "Calcutta" or similar wagering pool in connection with a golf tournament.

Advice has been requested whether the taxes on wagering apply to the operation of a "Calcutta" or similar wagering pool by a hotel corporation in connection with a golf tournament which it sponsors, where a portion of the receipts from the pool are retained by the hotel for use in promoting the next year's tournament.

The tournament is held annually, primarily for the favorable publicity that is derived from such an affair. The pool is operated in the following manner: After the qualifying play for the tournament has been completed and a certain number of golfers have advanced to the championship flight, tickets are sold to persons who then participate in a drawing conducted by the hotel for the names of those golfers who have reached the championship flight. The hotel retains a percentage of the proceeds from the sale of the tickets and places the balance in a pool. Each player whose name is drawn is then "auctioned" to the highest bidder. The ticket holder who had drawn that golfer's name receives a percentage of the price for which the golfer is auctioned. The hotel retains a portion of the remainder of the proceeds from the auction and places the balance in the pool. Upon completion of the tournament, the pool is divided on a percentage basis among those persons to whom the winning golfers have been auctioned. The portion of the proceeds of the drawing and the auction retained by the hotel is used by it to defray the expenses of operating the pool and the balance is held for expenses in connection with a similar tournament to be held the following year.

Section 4401 of the Internal Revenue Code of 1954 imposes on wagers an excise tax equal to 10 percent of the amount thereof. Section 4421

defines the term "wager" as including any wager placed in a wagering pool with respect to a sports event or a contest, if such pool is conducted for profit.

Section 4411 of the Code imposes a special tax of $50 per year to be paid by each person who is liable for tax under section 4401 or who is engaged in receiving wagers for or on behalf of any person so liable.

Under the circumstances described, the portion of the proceeds from the pool which is retained by the hotel to be applied to the expenses of a subsequent tournament constitutes a profit from the operation of the pool for purposes of the wagering tax. Furthermore, even if the hotel did not retain any portion of the proceeds from the pool, it must be assumed that in the operation of such a pool there is an expectancy of other benefits, such as advertising the establishment or increasing attendance at a tournament to which there are charges for admission.

It is considered that this expectancy of indirect benefits constitutes "profit" for purposes of the wagering tax. For a similar conclusion relating to lotteries operated by merchants as trade stimulators, see Revenue Ruling 54–256, C. B. 1954–2, 401.

Accordingly, it is held that the drawing and auction conducted by the hotel constitute a wagering pool conducted for profit. The hotel corporation, as the operator of the pool, is liable for the wagering excise tax imposed by section 4401 of the Code, computed at 10 percent of the total of the amount for which the tickets for the drawing are sold and the amount for which the players are auctioned. Likewise, the corporation is liable for the $50 special tax imposed by section 4411 of the Code. Liability for the $50 special tax is incurred also by each individual, including any officer of the corporation, who receives wagers for or on its behalf.

SUBCHAPTER B.—OCCUPATIONAL TAX

SECTION 4411.—IMPOSITION OF TAX

Applicability of the taxes on wagering, imposed by sections 4401 and 4411 of the Internal Revenue Code of 1954, to the operation of a "Calcutta" or similar wagering pool in connection with a golf tournament. See Rev. Rul. 56–72, page 532.

CHAPTER 36.—CERTAIN OTHER EXCISE TAXES

SUBCHAPTER B.—OCCUPATIONAL TAX ON COIN-OPERATED DEVICES

SECTION 4462.—DEFINITION OF COIN-OPERATED AMUSEMENT OR GAMING DEVICE

Rev. Rul. 56–139

Two coin-operated machines have been converted in such a manner that they can be activated by one handle. They have separate coin

slots, separate reels, and separate pay-off mechanisms, and each operates independently after they are set in motion. *Held*, a coin-operated machine that operates as two distinct units, except for a common handle, and whose operation is determined by the element of chance, is taxable as two coin-operated gaming devices, notwithstanding the fact that it is activated by a single handle.

SUBTITLE E.—ALCOHOL, TOBACCO AND CERTAIN OTHER EXCISE TAXES

CHAPTER 52.—TOBACCO, CIGARS, CIGARETTES, AND CIGARETTE PAPERS AND TUBES

SUBCHAPTER A.—DEFINITIONS; RATE AND PAYMENT OF TAX; EXEMPTION FROM TAX; AND REFUND AND DRAWBACK OF TAX

SECTION 5702.—DEFINITIONS

26 CFR 280.16: Dealer in tobacco materials. Rev. Rul. 56-149

An exporter of tobacco materials who has shipments consigned to him and who handles the tobacco to the extent of arranging export transportation and delivery to the proper port of exportation must qualify as a dealer in tobacco materials. An exporter who has shipments consigned by the supplier directly to the purchaser or consignee in the foreign country, and the shipments are made by the supplier directly to the export vessel or other export carrier, is not required to qualify as a dealer in tobacco materials.

Advice has been requested whether an exporter of tobacco materials who deals solely in export shipments of such materials which are made direct from his suppliers to the export vessel or other export carrier is a dealer in tobacco materials and required to qualify as such.

Section 5702(1) of the Internal Revenue Code of 1954 defines a dealer in tobacco materials as any person who *handles* tobacco materials for sale, shipment, or delivery solely to another dealer in such materials, to a manufacturer of tobacco products, or to a foreign country, Puerto Rico, the Virgin Islands, or a possession of the United States. That section lists certain exceptions to the definition not here pertinent.

It is held that where an exporter of tobacco materials has shipments consigned to him by the suppliers of the tobacco and it is necessary for him to handle the tobacco to the extent of arranging export transportation and seeing to it that the tobacco is delivered to the proper export vessel or other carrier, he must qualify as a dealer in tobacco materials. However, where the exporter has the shipments consigned by his suppliers directly to the purchaser or consignee in the foreign country and such shipments are made by the suppliers directly to the export vessels or other export carriers, the exporter need not qualify as a dealer in tobacco materials.

SECTION 5703.—LIABILITY FOR TAX AND METHOD OF PAYMENT

Rev. Rul. 56–193

Tobacco tax stamps attached to packages of cigars, cigarettes, or manufactured tobacco are not required to be canceled under the Internal Revenue Code of 1954.

Advice has been requested whether it is necessary to cancel internal revenue tax stamps affixed to packages of tobacco products under the provisions of the Internal Revenue Code of 1954 and the regulations promulgated thereunder.

The Regulations relating to Cigars and Cigarettes (Manufacturers, Importers, and Dealers) and the Regulations relating to Manufactured Tobacco (Manufacturers, Importers, and Dealers) make no provision for the cancellation of internal revenue tax stamps affixed to packages of tobacco products. Such regulations do require that the tobacco tax stamps be securely affixed to the packages. Although prior regulations required that the stamps either be affixed in such manner as to seal the package or be canceled, experience has demonstrated that such requirements served no useful purpose, and, as of the effective dates of the regulations referred to above, manufacturers of cigars, cigarettes, and manufactured tobacco have not been required to cancel the internal revenue tobacco tax stamps regardless of their location on packages.

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26 CFR 270.148: Stamps.

For the method of receipting tobacco tax stamp order forms, see Rev. Proc. 56–1, page 1016.

For instructions with respect to the preparation and distribution of Form 168, Order for Stamps for Large Cigars, see Rev. Proc. 56–16, page 1041.

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26 CFR 270.192: Stamps.

For the method of receipting tobacco tax stamp order forms, see Rev. Proc. 56–1, page 1016.

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26 CFR 275.137: Stamps.

A new 22-ounce denomination internal revenue manufactured tobacco tax stamp has been issued. See Rev. Proc. 56–20, page 1045.

For the method of receipting tobacco tax stamp order forms, see Rev. Proc. 56–1, page 1016.

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26 CFR 275.181: Stamps.

For the method of receipting tobacco tax stamp order forms, see Rev. Proc. 56–1, page 1016.

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SECTION 5705.—REFUND OR ALLOWANCE OF TAX

(Also Part II, Section 2198.) Rev. Rul. 56–150

A claim for redemption of cigarette tax stamps filed by a manufacturer or importer of tobacco products after the period of limitation has expired cannot be allowed, notwithstanding the fact that the tobacco products were held in custody by a United States marshal.

Advice has been requested whether a claim, filed after the expiration date of the statutory period of limitation, for redemption of cigarette tax stamps allegedly attached to cigarettes withdrawn from the market, can be allowed where the cigarettes were held in custody by a United States marshal.

Tobacco tax stamps purchased prior to January 1, 1955, are subject to redemption under section 2198 of the Internal Revenue Code of 1939. This section provides, in part, that internal revenue tax stamps affixed to packages of tobacco products withdrawn from the market by a manufacturer or importer may be redeemed, provided claim for their redemption is presented by the manufacturer or importer within three years after the year of issue, as indicated by the series number printed thereon by the Government, irrespective of the date of their purchase. Stamps purchased on or after January 1, 1955, are subject to redemption pursuant to section 5705 of the Internal Revenue Code of 1954, which provides that claims must be filed within three years of the date of payment of the tax.

In view of the specific provisions of the statutes, the fact that the tobacco products were held in custody by a United States marshal does not stop the running of the period of limitation set forth therein or extend such period. Accordingly, although the tobacco products withdrawn from the market were held in custody by a United States marshal, a claim for redemption of the tax stamps attached to such tobacco products cannot be allowed where claim therefor is filed by the manufacturer or importer after the period of limitation prescribed by section 2198 of the 1939 Code or section 5705 of the 1954 Code, as the case may be, has expired.

SUBCHAPTER B.—QUALIFICATION REQUIREMENTS FOR MANUFACTURERS OF ARTICLES AND DEALERS IN TOBACCO MATERIALS

SECTION 5711.—BOND

26 CFR 270.156: Storage of tobacco materials. Rev. Rul. 56–140
(Also Sections 275.145, 280.65.)

Requirements and restrictions placed on the storage, shipment, and delivery of tobacco materials.

Advice has been requested with respect to the requirements of the tobacco regulations covering the storage, shipment, and delivery of tobacco materials.

Section 280.50 of the Regulations relating to Dealers in Tobacco Materials exempts warehousemen from qualifying as dealers in tobacco

materials. However, where such a warehouseman stores tobacco materials for a dealer in tobacco materials or a manufacturer of tobacco products, it is necessary for such dealer or manufacturer to include the warehouse as an outside place of storage in connection with his qualification as a dealer or a manufacturer. The use of such warehouses as outside places of storage is permitted under the Internal Revenue Code of 1954 and the regulations in order to provide dealers in tobacco materials and manufacturers of tobacco products with greater freedom in their operations, and to liberalize the controls and requirements formerly imposed, in connection with tobacco materials.

Under the provisions of section 270.156 of the Regulations relating to Cigars and Cigarettes (manufacturers, importers, and dealers) and section 275.145 of the Regulations relating to Manufactured Tobacco (manufacturers, importers, and dealers), manufacturers of tobacco products are permitted certain industry operations and functions beyond city, town, or state lines. However, for reasons of effective administration, such operations and functions are not permitted to be extended across internal revenue regional boundaries except in the case of the use of outside places of storage of tobacco materials by dealers in tobacco materials. Accordingly, a qualified dealer in tobacco materials is permitted to include in the premises of his establishment any buildings, or portions of buildings, in the same Internal Revenue Region, to be used by him in carrying on such business. In such case, consolidated records must be maintained by him, at one of the buildings comprising his establishment, of all tobacco materials received and handled under his bond and permit. A dealer in tobacco materials may, however, elect to exclude from the premises of his establishment any buildings in the same region in which his establishment is located which he uses merely for the storage of his tobacco materials. Such buildings as are excluded from the premises of his establishment must be shown by the dealer as outside places of storage. Under the Regulations relating to Dealers in Tobacco Materials, each such dealer is also permitted to cover under the bond and permit of his establishment any warehouses in the United States as outside places of storage, provided consolidated records of all tobacco materials received therein are maintained at the qualified establishment of the dealer.

A qualified manufacturer of tobacco products may be permitted to include in the premises of his factory any buildings, or portions of buildings, in the same city, town, or village, to be used by him in carrying on his business. In addition, he is also permitted to cover under his factory bond any warehouses in the same region as his factory as outside places of storage.

Outside places of storage are restricted to the storage of tobacco materials, including fumigation of tobacco materials. The premises of the establishment of a qualified dealer in tobacco materials or the factory of a qualified manufacturer of tobacco products can not be shown as an outside place of storage by other dealers or manufacturers. However, a warehouse intended to be used merely as an outside place of storage may be qualified by a number of dealers and manufacturers as an outside place of storage.

A qualified dealer in tobacco materials may show the premises of a warehouseman as an outside place of storage for his tobacco

materials. Similarly, a qualified manufacturer of tobacco products may show the premises of a warehouseman located in the same region as his factory as an outside place of storage for his tobacco materials. However, where such warehouseman operates more than one storage warehouse in the same city, town, or village, it will be sufficient for the qualified dealer or manufacturer to show as his outside place of storage the principal warehouse address of the warehouseman to whom the tobacco materials are shipped for storage.

All tobacco materials stored by a dealer in the premises of his establishment for other qualified dealers or manufacturers of tobacco products should be carried in the records of the storing dealer and such tobacco materials should be shown in the records of the shipping dealer or manufacturer as having been shipped to the storage dealer. Similarly, when the tobacco materials are shipped out of storage, a record of the shipment should be made in the records of the storing dealer, and a record of the receipt of such materials should be made in the records of the dealer or manufacturer to whom shipped, when the tobacco materials are actually received in the latter's establishment or factory or outside place of storage.

In filing Form 2093, Application for Permit, required to be filed by every person to qualify as a dealer in tobacco materials, the applicant should appropriately set forth under Item 3 of the form the location of each building, or portion of a building, in the same Internal Revenue Region, to be included in the premises of his qualified establishment. The building of such establishment in which consolidated records of the dealer's operations will be maintained should be properly indicated by the use of the term "Major location" or "Records maintained here."

Inquiries in regard to this Revenue Ruling should refer to the number thereof and should be directed to the appropriate Assistant Regional Commissioner, Alcohol and Tobacco Tax.

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26 CFR 275.112: Amount of bond. T. D. 6170[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER E, PART 275.—MANUFACTURED TOBACCO—MANUFACTURERS, IMPORTERS, AND DEALERS

TREASURY DEPARTMENT
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On January 24, 1956, a notice of proposed rulemaking with respect to regulations designated as Part 275 of Title 26 (1954) of the Code of Federal Regulations was published in the Federal Register (21 F. R. 544). The purposes of the proposal were to prescribe that packages of imported manufactured tobacco bear a warning similar to that required on packages of domestic maufactured tobacco and to clarify the provisions relating to the amount of bonds. After consideration of all such relevant matter as was presented by interested persons relating to the rules proposed, the amendment to 26 CFR (1954) part 275, set forth below, is hereby adopted.

[1] 21 F. R. 2616.

PARAGRAPH 1. Section 275.112 is amended by striking out, in the first sentence thereof, the words "equal to" and inserting, in lieu therof, the words "not less than".

This Treasury Decision shall be effective on the first day of the first month which begins not less than 30 days following the date of publication in the Federal Register.

(This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U. S. C. 7805).)

O. GORDON DELK,
Acting Commissioner of Internal Revenue.

Approved April 19, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Published in the Federal Register April 24, 1956)

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26 CFR 275.145: Storage of tobacco materials.

For requirements and restrictions regarding the storage, shipment, and delivery of tobacco materials. See Rev. Rul. 56–140, page 536.

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26 CFR 280.65: Bond.

For requirements and restrictions regarding the storage, shipment, and delivery of tobacco materials. See Rev. Rul. 56–140, page 536.

SUBCHAPTER C.—OPERATIONS BY MANUFACTURERS OF ARTICLES

SECTION 5721.—INVENTORIES

26 CFR 270.141: Inventories. Rev. Rul. 56–73
(Also 275.131; Section 5722; 270.143, 275.133.)

Manufacturers of tobacco products are no longer required to report the use of tobacco materials in the manufacture of tobacco products. Such information has heretofore been reported in item 9 of Form 2134, Monthly Report—Manufacturer of Tobacco, in the case of manufactured tobacco, and in item 9 of Form 2136, Monthly Report—Manufacturer of Cigars and Cigarettes, in the case of cigars and cigarettes. In lieu of reporting tobacco materials used monthly, each manufacturer of tobacco products will render an inventory of tobacco materials held in each tobacco products factory at the close of December 31 of each year. Such inventories, in connection with the present monthly reports of tobacco materials received, lost or destroyed, and removed, will enable the Internal Revenue Service to determine the quantities of tobacco materials used in each factory during the calendar year for audit and statistical purposes. The taking of inventories is required under the authority of section 5721 of the Internal Revenue Code of 1954 and sections 270.141(c) and 275.131(c) of the Regulations relat-

ing to Cigars and Cigarettes (Manufacturers, Importers, and Dealers), and to Manufactured Tobacco (Manufacturers, Importers, and Dealers), respectively.

Section 11 of Revenue Procedure 55–12, C. B. 1955–2, 914, contained instructions to be followed until Form 2136 was available for distribution. Therefore, since Form 2136 is now in use, Revenue Procedure 55–12, *supra*, is hereby modified by eliminating therefrom section 11.

For instructions with respect to inventory required to be made by tobacco manufacturers of tobacco materials on hand at the beginning of business on January 1, 1956, see Rev. Proc. 56–3, page 1018.

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26 CFR 275.131: Inventories.

For instructions with respect to inventory required to be made by tobacco manufacturers of tobacco materials on hand at the beginning of business on January 1, 1956, see Rev. Proc. 56–3, page 1018.

For requirement that an annual inventory be taken by tobacco manufacturers of tobacco materials used, see Rev. Rul. 56–73, above.

SECTION 5722.—REPORTS

26 CFR 270.143: Reports. T. D. 6156[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER E, PART 270.—CIGARS AND CIGARETTES—MANUFACTURERS, IMPORTERS, AND DEALERS

Elimination of the requirement for reporting tobacco materials used by manufacturers of cigars and cigarettes.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

In order to eliminate the requirement in 26 CFR (1954) part 270, for the monthly reporting by manufacturers of cigars and cigarettes of tobacco materials used in the manufacture of their products, such regulations are hereby amended as follows:

PARAGRAPH 1. Section 270.143, relating to monthly reports, is amended by striking from the first sentence thereof, where it appears the first time, the word "used,".

Because the amendment made by this Treasury Decision relieves restrictions presently in the regulations, it is found unnecessary to issue this Treasury Decision with notice and public procedure thereon under section 4(a) of the Administrative Procedure Act, or subject to the effective date limitation of section 4(c) of said Act.

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[1] 20 F. R. 10155.

This Treasury Decision shall be effective on the date of its publication in the Federal Register.

(This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code (68A Stat. 917; 26 U. S. C. 7805).)

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved December 28, 1955.

H. CHAPMAN ROSE,
Acting Secretary of the Treasury.

(Published in the Federal Register, December 31, 1955)

(Also Section 275.133.) Rev. Rul. 56–74

Section I of Form 2134, Monthly Report—Manufacturer of Tobacco, and Section I of Form 2136, Monthly Report—Manufacturer of Cigars and Cigarettes, provide for the reporting of tobacco materials received, shipped, lost, and destroyed by kinds of materials as defined in the Regulations relating to Cigars and Cigarettes (manufacturers, importers, and dealers) and in the Regulations relating to Manufactured Tobacco (manufacturers, importers, and dealers). In lieu of the reporting of transactions in tobacco materials in the manner indicated on the forms, such materials will be reported by manufacturers under the classifications of *unstemmed* and *stemmed* leaf tobacco only, in the manner indicated herein. Black Fat tobacco received, shipped, lost, and destroyed shall be included in the column relating to unstemmed leaf tobacco. Perique tobacco, tobacco in process, scraps, cuttings, clippings, and siftings received, shipped, lost, and destroyed shall be included in the column relating to stemmed leaf tobacco. Tobacco materials acquired by the reduction of tobacco products shall be similarly included. Stems received into the factory or outside place of storage (not those accumulated from stemming operations in the factory) shall also be included in the column relating to stemmed leaf tobacco. Only those stems so received, which are thereafter lost or destroyed, shall be so reported and similarly included. All stems shipped to manufacturers of tobacco products, dealers in tobacco materials, or for purposes other than fertilizer, insecticide, or nicotine, shall be reported and included in the column relating to stemmed leaf tobacco. Waste tobacco materials shipped, lost, or destroyed shall not be included in such reports.

For requirements with respect to entries by manufacturers in their factory revenue record covering materials received, shipped, lost, and destroyed, see Rev. Rul. 56–76, page 548.

For elimination of requirement that tobacco materials used in the manufacture of tobacco products be shown on the monthly report, see Rev. Rul. 56–73, page 539.

26 CFR 275.133: Reports. T. D. 6157[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER E, PART 275.—MANUFACTURED TOBACCO: MANUFACTURERS, IMPORTERS, AND DEALERS

Elimination of the requirement for reporting tobacco materials used by manufacturers of tobacco.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

In order to eliminate the requirement in 26 CFR (1954) part 275, for the monthly reporting by manufacturers of tobacco, of tobacco materials used in the manufacture of their product, such regulations are hereby amended as follows:

PARAGRAPH 1. Section 275.133, relating to monthly reports, is amended by striking from the first sentence thereof, where it appears the first time, the word "used,".

Because the amendment made by this Treasury Decision relieves restrictions presently in the regulations, it is found unnecessary to issue this Treasury Decision with notice and public procedure thereon under section 4(a) of the Administrative Procedure Act, or subject to the effective date limitation of section 4(c) of said Act.

The Treasury Decision shall be effective on the date of its publication in the Federal Register.

(This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code (68A Stat. 917; 26 U. S. C. 7805).)

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved December 28, 1955.

H. CHAPMAN ROSE,
Acting Secretary of the Treasury.

(Published in the Federal Register December 31, 1955)

For elimination of requirement that tobacco materials used in the manufacture of tobacco products be shown on the monthly report, see Rev. Rul. 56–73, page 539.

For the method of reporting tobacco materials received, shipped, lost, and destroyed on the monthly report of manufacturers of tobacco, Rev. Rul. 56–73, page 539.

SECTION 5723.—PACKAGES, LABELS, NOTICES, AND STAMPS

Rev. Rul. 56–17

The legend, shown herein, required by article 5 (a) (3) of Regulations 73 and article 5(a)(3) of Regulations 76, made applicable to the Internal Revenue Code of 1954 by virtue of Treasury Decision

[1] 20 F. R. 10155.

6091, C. B. 1954–2, 47, may be omitted from cases of tobacco products removed from the factory, without payment of tax, for export and sea stores purposes.

Requests have been received by the Internal Revenue Service for permission to omit the legend required by article 5(a)(3) of Regulations 73, Exportation Without Payment of Tax of Tobacco Manufactures, etc., and article 5(a)(3) of Regulations 76, Shipment or Delivery of Manufactured Tobacco, Snuff, Cigars, or Cigarettes for Use as Sea Stores Without Payment of Internal-Revenue Tax, to be shown on cases of tobacco products removed free of tax for export and sea stores purposes.

Articles 5(a)(3) of Regulations 73 and Regulations 76 (applicable to the 1954 Code by virtue of T. D. 6091, C. B. 1954–2, 47) require the legend

---------- from export (or sea stores)
(Name of article)
By ----------
Fac. No. ---------- Dist. ----------

to be shown on cases of tobacco products removed free of tax for export or for sea stores purposes.

Authority was granted during World War II, for reasons of military security, to omit the legend from cases of tobacco products removed, without payment of tax, for delivery to the Armed Forces of the United States, for exportation or for use as sea stores. This authority has not been rescinded since it has been determined that the legend serves no useful purpose and its appearance on such cases of tobacco products, which shows the kind of merchandise contained therein, encourages pilferage and unlawful diversion of the products. For the same reasons, the National Office has, from time to time, approved specific requests, when submitted by manufacturers, to omit the above legend from cases of tobacco products removed for the purposes indicated.

In view of the above, where a manufacturer of tobacco, cigars, or cigarettes so desires, he may omit the legend referred to from cases of such products removed from his factory, without payment of tax, for export or for use as sea stores. However, cases of tobacco products so removed must be numbered for identification and accounting purposes.

This arrangement conforms with the proposed new export and sea stores regulations, 26 CFR 290, which are now in preparation and are expected to be published in the near future.

Inquiries in regard to the provisions of this Revenue Ruling should be directed to the appropriate Assistant Regional Commissioner, Alcohol and Tobacco Tax.

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26 CFR 270.144: Packages. Rev. Rul. 56–141
(Also Section 275.134.)

Procedures applicable to the transfer of stamped (taxpaid) packages of tobacco products from one factory to another factory, for the purpose of consolidating shipments of such products, are established.

Advice has been requested as to the procedures to be followed in transferring stamped packages of tobacco products from one factory

to another factory producing the same kind of tobacco products, for the purpose of consolidating shipments thereof.

Section 270.144 of the Regulations relating to Cigars and Cigarettes (manufacturers, importers, and dealers) provides, in part, that all cigars and cigarettes shall, before removal, be put up by the manufacturer in packages which bear the proper stamps and mark, except that cigars and cigarettes transferred to another manufacturer of such products shall be exempt from these package requirements. Section 270.152 provides that a manufacturer of cigars and cigarettes may transfer such products, under his bond, without the payment of tax, to any qualified manufacturer of such products. Similar provisions are made in sections 275.134 and 275.141 of the Regulations relating to Manufactured Tobacco (manufacturers, importers, and dealers) with respect to manufactured tobacco. Procedures are not established in the regulations covering the transfer of packaged, taxpaid tobacco products between factories.

Although the regulations do not provide procedures for the transfer of tobacco products, upon taxpayment, between factories, packages of tobacco products, upon which the tax has been paid and which bear the appropriate stamps and marks, may be received on the bonded premises of a tobacco factory at which the same kind of tobacco products are manufactured if, prior to such transfer, the proprietor of the receiving tobacco or cigar and cigarette factory has made application to, and received permission from, the Assistant Regional Commissioner, Alcohol and Tobacco Tax, for the region in which his factory is situated. Such application shall set forth the products and the kind, quantity, and, in the case of large cigars, the class designation, to be received. If it is desired to receive a number of such shipments into the bonded premises, the appropriate Assistant Regional Commissioner may grant blanket authority to the proprietor of the receiving factory to receive stamped (taxpaid) tobacco products transferred from other factories, provided the proprietor of such factory furnishes him, with respect to each lot or shipment received, the information indicated above as to kind, quantity, etc.

For accounting purposes, the proprietor of the shipping factory will record the products and the tax stamps affixed thereto in the usual manner. Such products and stamps should also be reported by him in the usual manner on appropriate monthly reports, Form 2134, Monthly Report—Manufacturer of Tobacco, or Form 2136, Monthly Report— Manufacturer of Cigars and Cigarettes, as "Removed Tax Paid" and "Affixed to Packages Removed."

In the case of the factory receiving such taxpaid tobacco products, the revenue records, Form 73, record of manufacturers of cigars and cigarettes, and Form 74, record of manufacturers of tobacco and snuff, should be modified by changing the heading of one of the unused columns to read "Received from Other Factories," and appropriate entry should be made in this column to show the total quantity of each lot of stamped tobacco products received into the bonded premises of the factory. Such entry should be supported by an appropriate notation indicating the factory from which the tobacco products were received. The tax stamps involved should be taken up in the revenue record of the receiving factory by separate appropriate entries under "Stamps Purchased." When the transferred stamped tobacco prod-

ucts are subsequently removed from the receiving factory, separate appropriate credit entries should be made in the revenue record, in the proper columns covering products removed taxpaid. Appropriate credit entries should also be made under stamps "Used" to show the value of the tax stamps attached to such products removed.

Pending revision of Forms 2134 and 2136, such tobacco products should be reported separately on the proper monthly report, under "Products Removed," in the appropriate columns, with a notation, "Formerly Received." The stamps attached to the products removed should be reported in the same monthly report, separately, in the proper columns under "Stamps Affixed to Packages Removed."

(Also Section 275.134.) Rev. Rul. 56–194

Stamped packages of manufactured tobacco, cigars, and cigarettes may be enclosed by manufacturers in outer containers for purposes of marketing and sale.

Advice has been requested whether packages of tobacco products bearing the required marks, notice, and tax stamp may be enclosed in outer containers.

The Regulations relating to Cigars and Cigarettes (Manufacturers, Importers, and Dealers) and the Regulations relating to Manufactured Tobacco (Manufacturers, Importers, and Dealers), issued pursuant to the Internal Revenue Code of 1954, do not prohibit the use of outer wrappers for packages of tobacco products. It is held that stamped packages of manufactured tobacco, cigars, and cigarettes may be enclosed in outer containers which may be sealed. Internal revenue officers are, of course, authorized to open such outer containers in the course of their inspection of tobacco products so packaged.

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26 CFR 270.146: Mark. Rev. Rul. 56–75
(Also Section 275.135; Section 295.54.)

The permit number of a tobacco manufacturer should be complete wherever used, including the letter "C" or "T" to indicate the kind of business covered, the number assigned to the factory, and the name of the state in which the factory is located.

Advice has been requested with respect to the appropriate method of showing the permit number of a tobacco manufacturer on packages of tobacco products, and in reports, inventories, and other documents filed with the Internal Revenue Service and other governmental agencies.

Section 270.146 of the Regulations relating to Cigars and Cigarettes (manufacturers, importers, and dealers) provides, in part, that every package of cigars and cigarettes subject to tax shall, before removal, have legibly imprinted thereon, or on a label securely affixed thereto, the name and location of the manufacturer, or his permit number. Section 275.135 of the Regulations relating to Manufactured Tobacco (manufacturers, importers, and dealers) sets forth similar requirements with respect to packages of manufactured tobacco subject to tax. Also, section 295.54 of the Regulations relating to Removal of Tobacco Products and Cigarette Papers and Tubes, without Payment

of Tax, for use of the United States, makes a similar requirement with respect to tobacco products removed for the use of the United States. The regulations require the preparation and filing of various forms which call for the insertion of the manufacturer's permit number.

Wherever the permit number of a tobacco manufacturer is required to be shown, it should be complete and should include (1) the letter "C" or "T" to indicate the kind of business in which the manufacturer is engaged, *i. e.*, manufacturer of *C*igars, *C*igarettes, or *T*obacco, (2) the numerals indicating the number assigned to the factory by the Assistant Regional Commissioner, Alcohol and Tobacco Tax, and (3) the name of the state, or proper abbreviation thereof, in which the factory is located, as for example:

Permit No. C-4978, Va., or
Permit T-5979-Texas.

Inquiries in regard to this Revenue Ruling should refer to the number thereof and should be directed to the appropriate Assistant Regional Commissioner, Alcohol and Tobacco Tax.

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26 CFR 270.149: Affixture of stamps. Rev. Rul. 56-113
(Also Section 275.138.)

The Regulations relating to Cigars and Cigarettes (manufacturers, importers, and dealers) and relating to Manufactured Tobacco (manufacturers, importers, and dealers) specify denominations of internal revenue stamps available for the payment of taxes on cigars, cigarettes, and manufactured tobacco, and provide that every manufacturer shall, before removal of such products subject to tax, securely affix to each package one or more stamps of such proper class and denominations as will fully taxpay the contents of the package. *Held*, since the Internal Revenue Code of 1954, and the pertinent regulations, do not prescribe or restrict the quantities of tobacco products which may be put up in packages for domestic sale or consumption, packages of various sizes may be approved for such tobacco products so long as sufficient tax stamps are affixed to the packages to fully taxpay the contents. For example, a manufacturer of cigars may package such products 60 to a package and affix thereto two internal revenue cigar tax stamps, one of denomination 50 and one of denomination 10, of the proper class, in payment of the tax thereon.

(Also 275.138.) Rev. Rul. 56-114

Internal revenue tobacco tax stamps may be affixed at any location on the package containing cigars, cigarettes, or manufactured tobacco.

A question has arisen with respect to the location, under the new tobacco regulations, of tobacco tax stamps on packages of cigars, cigarettes, and manufactured tobacco.

The Regulations relating to Cigars and Cigarettes (manufacturers, importers, and dealers) provide that manufacturers and importers of cigars and cigarettes shall, before removal subject to tax, securely affix to each package of such products one or more stamps of such proper class and denominations as will fully taxpay the contents of

the package. A similar provision is contained in the Regulations relating to Manufactured Tobacco (manufacturers, importers, and dealers) with respect to manufactured tobacco.

It is held that the required internal revenue tobacco tax stamps may be affixed at any location on the package as desired by the manufacturer or importer, provided the stamps are securely affixed.

(Also Section 275.138.) Rev. Rul. 56–142

A question has arisen whether the placing of a loose internal revenue tobacco tax stamp inside a clear plastic package, so that it will be held in place by the cigars pressing down on the stamp, may be interpreted to be "securely affixed to the package" within the meaning of the regulations. Under the provisions of section 270.149 of the Regulations relating to Cigars and Cigarettes (manufacturers, importers, and dealers) and section 275.138 of the Regulations relating to Manufactured Tobacco (manufacturers, importers, and dealers), the internal revenue tax stamps used for payment of the tax on tobacco products must be securely affixed to each package. *Held*, the placing of a loose stamp inside a package so that it will be held in place by the tobacco products pressing down on the stamp (which would thereafter be available for reuse) does not satisfy the requirements of the regulations that the stamp be securely affixed to the package and is not permitted.

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26 CFR 275.134: Packages.

For the transfer of stamped packages of manufactured tobacco from one factory to another, see Rev. Rul. 56–141, page 543.

Stamped packages of tobacco products contained in outer wrappers. See Rev. Rul. 56–194, page 545.

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26 CFR 275.135: Mark.

For method of showing the permit number of a tobacco manufacturer on packages, reports, etc., see Rev. Rul. 56–75, page 545.

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26 CFR 275.138: Affixture of stamps.

Sizes of packages which may be approved for the packaging of manufactured tobacco. See Rev. Rul. 56–113, page 546.

For the method of affixing tobacco tax stamps to packages of tobacco, see Rev. Rul. 56–114, page 546.

Placing of loose tobacco tax stamp inside a package of tobacco products. See Rev. Rul. 56–142, page 547.

26 CFR 295.54: Mark.

For method of showing the permit number of a tobacco manufacturer on packages, reports, etc., see Rev. Rul. 56–75, page 545.

SUBCHAPTER D.—OPERATIONS BY DEALERS IN TOBACCO MATERIALS

SECTION 5731.—SHIPMENTS AND DELIVERIES RESTRICTED

26 CFR 280.120: Restrictions on handling, shipment, and delivery of tobacco materials. — Rev. Rul. 56–143

A tobacco material processed into rolls for use as a binder in the manufacture of cigars is considered as tobacco material and may be handled by a dealer in tobacco materials.

Advice has been requested whether tobacco processed into rolls for use as a binder in the manufacture of cigars may be produced and handled by dealers in tobacco materials.

Section 280.120 of the Regulations relating to Dealers in Tobacco Materials provides that a dealer in tobacco materials may handle such materials in any manner, provided he does not package them for consumption by smoking or for use in the mouth or nose. Section 280.33 includes "tobacco in process" as a part of the definition of tobacco materials.

The tobacco binder is considered to be a form of tobacco material suitable for use in the manufacture of a tobacco product (cigars). Tobacco materials may be handled by a person who qualifies as a dealer in tobacco materials. Accordingly, tobacco processed into rolls for use as a binder in the manufacture of cigars may be produced and handled by dealers in tobacco materials. For accounting purposes, such material should be regarded as stemmed leaf tobacco and should be so reported on the records of the dealer and of the person to whom such tobacco materials are shipped.

SUBCHAPTER E.—RECORDS OF MANUFACTURERS OF ARTICLES AND DEALERS IN TOBACCO MATERIALS

SECTION 5741.—RECORDS TO BE MAINTAINED

26 CFR 270.142: Record. (Also Section 275.132.) — Rev. Rul. 56–76

A uniform procedure is established for the keeping of tobacco, cigar, and cigarette factory records on Forms 73–Part 1, 73–Part 2, and 74, with respect to tobacco materials received, shipped, lost, and destroyed.

The Internal Revenue Service has found it necessary to establish a uniform method for the keeping of factory revenue records on Form 73–Part 1, Book to be Kept by Manufacturers of Large Cigars,

Form 73–Part 2, Book for Use by Manufacturers of Small Cigarettes, Large Cigarettes, or Small Cigars, and Form 74, Book to be Kept by Manufacturers of Tobacco and Snuff, since such forms do not provide columns for recording all such entries of each specific kind of tobacco materials. Accordingly, the following instructions are issued:

With respect to records to be kept on Forms 73–Part 1 and 73–Part 2, Black Fat tobacco received, shipped, lost, and destroyed shall be included in the columns relating to *unstemmed* leaf tobacco and entered in the appropriate columns (debit or credit) so designated. Perique tobacco received, shipped, lost, and destroyed shall be included in the columns relating to *stemmed* leaf tobacco and entered in the appropriate columns (debit or credit) so designated. Tobacco in process, as well as siftings, received, shipped, lost, and destroyed shall be included under *scraps, cuttings, and clippings*, and entered in the appropriate columns (debit or credit) so designated. Tobacco materials acquired by the reduction of cigars or cigarettes to materials shall be similarly recorded, with the notation "Acquired by reduction of product." Stems *received* into the factory or outside place of storage (not those accumulated from stemming operations in the factory) shall also be included under *scraps, cuttings, and clippings* and entered in the debit column of such materials received. If such stems are thereafter lost or destroyed, they shall be similarly included and entered in the credit column of scraps, cuttings, and clippings shipped. All stems shipped to manufacturers of tobacco products or dealers in tobacco materials, or for purposes other than fertilizer, insecticide, or nicotine, shall be entered in the credit column designated "Stems or Waste" shipped, but the designation of such column shall be changed to read "Stems Shipped to Manufacturers, Dealers, Etc." Waste tobacco materials shipped, lost, or destroyed need not be recorded. With respect to an entry covering the loss or destruction of tobacco materials, which is required to be entered in the factory revenue records, a notation showing the nature of the loss, etc., shall be made in the column designated "To Whom Shipped or Delivered," in the case of Form 73–Part 1, or in the column designated "To Whom Shipped," in the case of Form 73–Part 2.

With respect to Form 74 maintained by manufacturers of tobacco and snuff, Black Fat tobacco received, shipped, lost, and destroyed shall be included in the columns relating to *unstemmed* leaf tobacco and entered in the appropriate columns (debit or credit) so designated. Perique tobacco received, shipped, lost, and destroyed shall be included in the columns relating to *stemmed* leaf tobacco and entered in the appropriate columns (debit or credit) so designated. Siftings received, shipped, lost, and destroyed shall be included under *scraps, cuttings, and clippings* and entered in the appropriate columns (debit or credit) so designated. Tobacco materials acquired by the reduction of manufactured tobacco to materials shall be similarly recorded, with the notation "Acquired by reduction of product." Only those stems *received* into the factory or outside place of storage (not those accumulated from stemming operations in the factory) shall be entered in the debit column designated "Tobacco Stems for

Manufacturing Purposes" received, and such designation shall be changed to read "Tobacco Stems." If such stems are shipped to manufacturers of tobacco products, dealers in tobacco materials, or for purposes other than fertilizer, insecticide, or nicotine, or are lost or destroyed, they shall be entered in the credit column designated "Tobacco Stems For Manufacturing Purposes" shipped, and the designation of such column changed to read "Tobacco Stems Shipped to Manufacturers, Dealers, Etc." Also, those stems accumulated from stemming operations within the factory which are shipped to such manufacturers, dealers, or for purposes other than fertilizer, insecticide, or nicotine, shall be entered in such column. Waste tobacco materials shipped, lost, or destroyed need not be recorded. With respect to an entry covering the loss or destruction of tobacco materials, a notation showing the nature of the loss, etc., shall be made in the column designated "To Whom Shipped or Delivered." Licorice, sugar, gum, and substances other than tobacco, received or removed, are not required to be recorded.

Inquiries in regard to this Revenue Ruling should refer to the number thereof and should be directed to the appropriate Assistant Regional Commissioner, Alcohol and Tobacco Tax.

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26 CFR 275.132: Record.

For entries to be made on Form 74, Book to be Kept by Manufacturers of Tobacco and Snuff, with respect to tobacco materials, see Rev. Rul. 56–76, page 548.

SUBCHAPTER F.—GENERAL PROVISIONS

SECTION 5752.—RESTRICTIONS RELATING TO USED LABELS, STAMPS, AND PACKAGES

26 CFR 270.149: Affixture of stamps. Rev. Rul. 56–295

The Internal Revenue Service has received numerous inquires relative to possible violation of the law where internal revenue stamps are affixed to the backs of packages of cigarettes since the stamps will not be broken or damaged when opening the package. Section 5752 of the Internal Revenue Code of 1954 provides that no person shall *empty* any package of cigarettes without destroying the internal revenue stamp thereon. While the statutory requirement is mandatory, the penal and civil provisions of Sections 5762(b) and 5761(a) are enforced only where the failure to destroy the stamp is willful or with intent to defraud the revenue. There is no requirement that the stamp be broken upon opening a package of cigarettes. Since the law does not specify the particular location on packages where stamps must be affixed, the placing of the stamp on the back of the package of cigarettes does not contravene the law. See Rev. Rul. 56–114, page 546 of this Bulletin.

CHAPTER 53.—MACHINE GUNS AND CERTAIN OTHER FIREARMS

SUBCHAPTER A.—TAXES

PART I.—SPECIAL (OCCUPATIONAL) TAXES

SECTION 5801.—TAX

26 CFR 179.50: Geographical scope of tax. Rev. Rul. 56–166
(Also Sections 5811, 179.95.)
(Also Part II; Federal Firearms Act, Section 2(a); 315.40.)

Section 5801 of the Internal Revenue Code of 1954 provides that on first engaging in business, and thereafter on or before the first day of July of each year, every importer, manufacturer, and dealer in firearms shall pay a special (occupational) tax at the rate specified therein. Section 5811 of the Code provides that there shall be levied, collected, and paid, a tax at the rate specified therein on firearms transferred in the United States. Section 2(a) of the Federal Firearms Act, 15 U. S. C. 902(a), makes it unlawful for any manufacturer or dealer, except a manufacturer or dealer having a license issued under section 3 thereof, to transport, ship, or receive any firearm or ammunition in interstate or foreign commerce. A question has arisen with respect to the application of these laws in the case of persons engaged in the business of selling firearms which remain in customs bond. *Held*, the transfer tax on firearms imposed under section 5811 of the Code is not applicable to the constructive transfer of firearms in customs territory. However, the transfer of legal title to firearms is equivalent to a sale thereof and any person engaged, within the United States, in the business of selling firearms held or stored in customs territory, or in transit through such territory, (1) incurs liability under section 5801 of the Code for the special (occupational) tax as a dealer in firearms and (2) must be properly licensed as an importer (manufacturer) or dealer under section 3(a) of the Federal Firearms Act, 15 U. S. C. 903, 52 Stat. 1251, if such firearms are transported, shipped, or received in interstate or foreign commerce under customs bond.

PART II.—TRANSFER TAX

SECTION 5811.—TAX

26 CFR 179.95: Scope of tax.

Liability for the transfer tax on firearms shipped in customs bond. See Rev. Rul. 56–166, above.

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PART IV.—OTHER TAXES

SUBCHAPTER B.—GENERAL PROVISIONS

SECTION 5848.—DEFINITIONS

26 CFR 179.20: Firearm. Rev. Rul. 56–28
(Also 179.40.)
(Also Part II, Federal Firearms Act, Section 1; 26 CFR 315.27.)

The Internal Revenue Service has had occasion to examine a device, identified as a "Molgun," which is made of an aluminum casting, approximately 6¼ inches in overall length and 5 inches in breadth, including a barrel housing, an exposed firing mechanism, and a removable insert chamber of 12-gauge bore. It is ostensibly designed to be set as a trap for small pests. This device has been test fired using a 12-gauge fixed shotgun shell loaded with No. 8 shot and found to perform satisfactorily with no structural damage to the device being incurred. *Held*, since the Molgun is capable of chambering and firing fixed shotgun shells and of being concealed on the person, such device is considered to be a firearm within the purview of the National Firearms Act (section 5848(1) and (5) of the Internal Revenue Code of 1954) and within the purview of the Federal Firearms Act (15 U. S. C. 901(3)), and is subject to the regulatory provisions thereof.

(Also Part II, Federal Firearms Act, Section 1; 26 CFR 315.27.) Rev. Rul. 56–29

A tear gas gun designed to expel only a gas or mist, and not capable of firing a shot or projectile, is not considered a firearm under either the National or Federal Firearms Act. If any such device is capable of firing other than the shells or cartridges designed for use therewith, such as fixed metallic cartridges or shotgun shells, it is a firearm within the purview of the National and/or Federal Firearms Act depending upon the physical characteristics of the individual weapon.

Advice has been requested whether small caliber guns which fire cartridges loaded with tear gas or a similar substance are subject to the provisions of the Federal Firearms Act or the National Firearms Act (Chapter 53 of the Internal Revenue Code of 1954).

Section 1 of the Federal Firearms Act, 15 U. S. C. 901, defines a firearm as "any weapon, by whatever name known, which is designed to expel a projectile or projectiles by the action of an explosive and a firearm muffler or firearm silencer, or any part or parts of such weapon."

Section 5848(1) of the Internal Revenue Code of 1954 defines a firearm as "a shotgun or rifle having a barrel of less than 18 inches in length, or any other weapon, except a pistol or revolver, from which a shot is discharged by an explosive if such weapon is capable of being concealed on the person, or a machine gun, and includes a muffler or silencer for any firearm whether or not such firearm is included within the foregoing definition, but does not include any rifle which is within the foregoing provisions solely by reason of the length of its barrel if the caliber of such rifle is .22 or smaller and if its barrel is 16 inches or more in length."

The classification of a weapon within the category of a firearm is dependent upon several conditions, as indicated in the above definitions of a "firearm," and the physical examination of the individual device is usually required to formulate a definite opinion. However, if a tear gas gun is designed to expel only a gas or other mist rather than a shot or a projectile, such a device is not classified as a firearm under either the National or Federal Firearms Act. If such a device is capable of firing other than the shells or cartridges designed for use therewith, such as fixed metallic cartridges or shotgun shells, it is a firearm within the purview of the National and/or Federal Firearms Act, depending upon the individual characteristics of the device. For example, see Revenue Ruling 55–529, C. B. 1955–2, 482, which classifies two weapons, designed to expel a gas mist but chambered to accommodate fixed shotgun shells or pistol or revolver ammunition, as firearms.

(Also Part II, Federal Firearms Act, Section 1; Section 315.27.) Rev. Rul. 56–47

The Internal Revenue Service has had occasion to examine and test a device identified as a "Protect-O-Lite," ostensibly designed to fire two .38 caliber gas shells simultaneously and to serve also as a flashlight, for the purpose of determining its classification under the National Firearms Act (section 5848 of the Internal Revenue Code of 1954) and the Federal Firearms Act (15 U. S. C. 901). Examination disclosed that the device is 9½ inches in overall length and is heavily constructed of magnesium aluminum alloy and steel. It employs a unique firing mechanism enclosed within the forward end, or head, of the flashlight. Two "barrels," with .38 caliber insert chambers constructed of nickel-chrome plated steel, are enclosed within the face plate directly above the reflector. The chambers must be removed for loading and the device may be satisfactorily aimed by directing a beam of light at the target. This device was test fired using .38 caliber, 146 grain wadcutter bullets and was found to perform satisfactorily with no structural damage to the device being incurred. *Held*, the Protect-O-Lite is a firearm within the purview of the National Firearms Act and the Federal Firearms Act and is subject to the regulatory provisions thereof.

Rev. Rul. 56–195

The Internal Revenue Service has had the occasion to examine a Remington rolling-block carbine of 7 mm. Mauser caliber converted into a 4¼ pound hand-gun type weapon chambered for the .257 Roberts rifle cartridge, with a 9⅛ inch barrel. *Held*, this weapon is a firearm as defined in section 5848(1) of the Internal Revenue Code of 1954, and, accordingly, it is subject to the regulatory provisions of the National Firearms Act (Chapter 53 of the Code).

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26 CFR 179.35: Pistol. Rev. Rul. 56–296

The Internal Revenue Service classifies a .22 caliber single shot match pistol with a five inch barrel, a .22 caliber single shot dueling pistol with a 6⅛ inch barrel, and a .22 caliber single shot weapon with a 16 inch barrel.

The question has arisen whether the three types of weapons described herein are firearms for purposes of the National Firearms Act (Chapter 53 of the Internal Revenue Code of 1954). The weapons are as follows:

(1) A .22 caliber "Powermaster," single shot match pistol, having a five inch barrel;

(2) A .22 caliber "Hamilton," single shot dueling pistol, having a 6⅛ inch barrel; and

(3) A .22 caliber "Horse Pistol," single shot, having a 16 inch barrel.

Section 5848(1) of the Internal Revenue Code of 1954 defines a firearm as follows:

> The term "firearm" means a shotgun or rifle having a barrel of less than 18 inches in length, or any other weapon, except a pistol or revolver, from which a shot is discharged by an explosive if such weapon is capable of being concealed on the person, or a machine gun, and includes a muffler or silencer for any firearm whether or not such firearm is included within the foregoing definition, but does not include any rifle which is within the foregoing provisions solely by reason of the length of its barrel if the caliber of such rifle is .22 or smaller and if its barrel is 16 inches or more in length.

Section 179.35 of the Regulations relating to Machine Guns and Certain Other Firearms defines a pistol as follows:

> "Pistol" shall mean a small projectile weapon having a short one-hand stock or butt at an angle to the line of the bore and a short barrel or barrels, designed, made and intended to be aimed and fired from one hand. The term shall not include gadget devices, guns altered or converted to resemble pistols, or small portable guns erroneously referred to as pistols, such as: Nazi belt buckle pistol, glove pistol, or one-hand stock guns, fixed shotgun or fixed rifle ammunition.

The "Powermaster" and "Hamilton," identified above in items (1) and (2), are small projectile weapons each having a short barrel, a short one-hand stock at an angle to the line of the bore, employing an "action" susceptible but not confined to use in either a single shot pistol or rifle, and designed to be aimed and fired from the hand. Accordingly, such pistols are not firearms within the intent of section 5848 of the Code.

The "Horse Pistol," identified above in item (3), although partially meeting the foregoing criteria, being popularly but improperly referred to as a "pistol," is not a pistol within the meaning of section 179.35 of the regulations due to the length of its barrel. More specifically, it is a gun designed to be held in one hand when fired and having a barrel of 12 inches or more but less than 18 inches in length from which only a single discharge can be made without manual reloading. Accordingly, the "Horse Pistol" is held to be a firearm within the purview of the National Firearms Act and is subject to the regulatory provisions thereof. The special (occupational) tax imposed on manufacturers and dealers in firearms of this classification is $25 per year and $1 per year, respectively. The rate of tax applicable to the transfer of firearms of this classification is $1. See sections 5801 and 5811 of the Code.

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26 CFR 179.40: Shotgun.

For classification of a "Molgun" designed ostensibly to be set as a trap for small pests, see Rev. Rul. 56–28, page 552.

SUBTITLE F.—PROCEDURE AND ADMINISTRATION

CHAPTER 61.—INFORMATION AND RETURNS

SUBCHAPTER A.—RETURNS AND RECORDS

PART I.—RECORDS, STATEMENTS, AND SPECIAL RETURNS

SECTION 6001.—NOTICE OR REGULATIONS REQUIRING RECORDS, STATEMENTS, AND SPECIAL RETURNS

(Also Sections 4081, 4091.) Rev. Rul. 56–260

Acceptability of microfilm reproductions of records of companies liable for manufacturers excise taxes on gasoline and lubricating oil.

Advice has been requested whether the retention of only microfilm reproductions of records by companies liable for manufacturers excise taxes on gasoline and lubricating oil, imposed by sections 4081 and 4091 of the Internal Revenue Code of 1954, meets the record keeping requirements of the law and regulations.

Section 6001 of the Code provides that every person liable for any tax imposed by the Code, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary of the Treasury or his delegate may from time to time prescribe.

Pursuant to the provisions of section 314.62 of Regulations 44, made applicable to the 1954 Code by Treasury Decision 6091, C. B. 1954–2, 47, every person required to file a return and pay tax on the sale or use of gasoline or lubricating oil must keep accurate and complete records and accounts with respect to such sale or use, together with duplicate returns. Records are required to be maintained in such a manner as to show:

(1) Quantity on hand at beginning of month;
(2) Quantity produced during the month;
(3) Quantity purchased tax free;
(4) Quantity purchased tax paid;
(5) Quantity sold tax free;
(6) Quantity sold subject to tax;
(7) Quantity used in production of other taxable commodities;
(8) Quantity used otherwise;
(9) Actual wastage, evaporation, and other losses, etc.; and
(10) Quantity on hand at end of month.

In I. T. 3866, C. B. 1947–2, 68, the Internal Revenue Service pointed out that it would be undesirable and impracticable to attempt to make income tax determinations on the basis of microfilm reproductions of general books of account, such as cash books, journals, voucher registers, ledgers, etc. It was held, however, that no objection will be interposed to the retention by taxpayers of only microfilm reproductions of supporting records of details, such as payroll records, cancelled checks, invoices, vouchers, etc., provided: (1) the taxpayer will retain microfilmed copies so long as the contents thereof may become material

in the administration of any internal revenue law; (2) the taxpayer will provide appropriate facilities for preservation of the films and for the ready inspection and location of the particular records, including a projector for viewing the records, in the event inspection is necessary for tax purposes; and (3) the taxpayer will be ready to make any transcriptions of the information contained on the microfilm which may be required.

Consistent with the policy stated in I. T. 3866, *supra*, it will be permissible for a company, liable for tax on gasoline or lubricating oil, to retain microfilm reproductions of supporting records, for example, (1) invoices showing transactions with customers and suppliers, (2) transfer invoices recording transactions within the company, and (3) exemption certificates and other documents supporting tax-free and nontaxable transactions. Permission to retain only microfilm reproductions of such supporting records is predicated upon the compliance by the company with the three conditions enumerated in I. T. 3866 regarding the retention, viewing, etc., of the microfilm reproductions. However, it will not be permissible for such a company to retain only microfilm reproductions of general books of account containing the type of information specified in section 314.62 of Regulations 44.

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26 CFR 31.6001–5; Additional records in connection with collection of income tax at source on wages.

Regulations under the 1954 Code with respect to withholding of income tax on amounts paid to employees after December 31, 1955, under wage continuation plans. See T. D. 6155, page 493.

PART II.—TAX RETURNS OR STATEMENTS

SUBPART A.—GENERAL REQUIREMENTS

SECTION 6011.—GENERAL REQUIREMENT OF RETURN, STATEMENT, OR LIST

(Also Sections 4001, 4011, 4021, and 4031.) Rev. Rul. 56–261

The Internal Revenue Service sets forth procedures whereby a retailer of articles subject to the retailers excise tax may compute and prepay the tax at the time the taxable articles are purchased, rather than when they are sold.

The Internal Revenue Service has received many requests from retailers of articles subject to Federal retailers excise tax that they be permitted to compute and prepay the tax at the time the taxable articles are purchased from their suppliers, rather than when they are sold. These requests are made for the most part by retail establishments where the sales of taxable articles comprise only a minor part of their business. Such retailers contend that such a procedure would simplify record keeping.

Retailers excise taxes are imposed by sections 4001, 4011, 4021, and 4031 of the Internal Revenue Code of 1954 upon the sale at retail of jewelry and related items, furs, toilet preparations, and luggage, handbags, etc., respectively.

The incidence of the above taxes is upon the sale of the articles at retail. However, the Service will interpose no objection to the computation and prepayment of the tax at the time the taxable articles are purchased by the retailer, provided (1) the tax so prepaid is computed on the established retail sale price of the articles; (2) the tax applicable to the retail sale price of any taxable articles on hand at the beginning of the period for which the prepayment plan is adopted is included in the Form 720, Quarterly Federal Excise Tax Return, filed for that period; (3) the retailer maintains (a) an accurate record of the inventory upon which tax is prepaid when the plan is adopted and (b) an accurate record of all taxable articles purchased by him showing the date of purchase and the purchase prices, as well as a record of the mark-up over purchase price used in arriving at the established retail price in each case; and (4) the prepayment method is used with respect to all articles subject to tax which he purchases for sale at retail.

Occasions may arise where, subsequent to the time of prepayment of tax under this plan, articles will be sold at prices higher than those used as a basis for computing the tax prepayment. In such cases, the additional tax resulting from the increase in retail sale prices must be included in the quarterly return for the period in which the articles are sold.

On the other hand, there may be occasions where there will be excess prepayments of tax for which a credit or refund will be allowable. Such excess prepayments might arise from the sale of articles at prices lower than the established retail prices upon which the prepayment was based, from a reduction in the applicable tax rate, or from the loss, destruction, or return to suppliers, of articles upon which tax has been prepaid. Interest will not be allowed upon such excess prepayments.

Each retailer who desires permission to prepay tax at the time of purchase of taxable articles, based upon the established retail sale price of the articles, should file a request in writing with his local District Director of Internal Revenue describing fully the nature of his business and the kinds of taxable articles handled. Prepayment of the tax by the retailer under this procedure should not be commenced until approval has been received from the District Director. Approval by District Directors of such requests will be conditioned upon the acceptance by the retailer of the requirements set forth herein and of the responsibility for maintaining such records and accounts as will enable internal revenue officers to determine whether the correct amount of tax has been paid to the Government.

Acceptable substitutes for Form 941a, "Continuation Sheet For Form 941, 941VI, or 943." See Rev. Proc. 56–10, page 1026.

SECTION 6012.—PERSONS REQUIRED TO MAKE RETURNS OF INCOME

(Also Section 1402.) Rev. Rul. 56-22

An income tax return, Form 1040, not accompanied by a prescribed power of attorney constitutes a valid return within the meaning of section 6012 of the Internal Revenue Code of 1954 when signed and filed by a wife on behalf of her mentally incompetent husband while she is managing his property prior to the appointment of a legal guardian.

Income derived from the husband's business, while it is managed by his wife during his disability before the appointment of a legal guardian, constitutes self-employment income to the husband within the meaning of section 1402 of the Internal Revenue Code of 1954.

Advice has been requested whether a wife can execute a valid income tax return on behalf of her husband while he is confined to a mental institution and before he is adjudicated to be of unsound mind (legally incompetent). Advice has also been requested whether income derived from the husband's business during such period, while it is managed by his wife in his behalf, constitutes self-employment income to the husband within the meaning of section 1402(b) of the Internal Revenue Code of 1954.

In the instant case, the husband, being unable to manage his own affairs, was committed to a mental institution and was subsequently adjudicated of unsound mind, at which time his wife was appointed legal guardian of his estate. During the period between the husband's commitment and his adjudication as being of unsound mind and while he was a patient in the mental institution, his business was operated by his wife. During such period, an income tax return, Form 1040, was signed and filed by the wife on behalf of the husband, without the benefit of a power of attorney from the husband. The return contained a notation to the effect that the self-employment income was not reported for the husband because he was mentally incompetent and because the business had been managed by his wife.

Section 6012(b)(2) of the Internal Revenue Code of 1954 provides that "If an individual is unable to make a return * * * the return of such individual shall be made by a duly authorized agent, his committee, guardian, fiduciary or other person charged with the care of the person or property of such individual." Under the provisions of this section, it appears that a wife is required to file returns for her incompetent spouse where she has taken over control of all his business affairs.

On the basis of the foregoing, it is held that an income tax return, Form 1040, although not accompanied by a prescribed power of attorney, constitutes a valid return within the meaning of section 6012 of the Internal Revenue Code of 1954 when signed and filed by a wife on behalf of her mentally incompetent husband while she is managing his property prior to the appointment of a legal guardian.

Section 1401 of the Code imposes a tax upon the self-employment income of every individual. Self-employment income means the net

earnings from self-employment as defined in section 1402(a). 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 subtitle A of the Code which are attributable to such trade or business plus his distributive share of the ordinary net income or loss from any trade or business carried on by a partnership of which he is a member, with certain exclusions and deductions therefrom as defined in section 1402(c) of the Code. The trade or business must be *carried on* by the individual, either personally or through agents or employees in order for the income to be included in his "net earnings from self-employment." Income derived by a beneficiary from an estate or trust, accordingly, is not derived from business carried on through the beneficiary's agents or employees. See Section 34.481–1(b) of Regulations 118, made applicable herein by T. D. 6091, C. B. 1954–2, 47.

It is concluded that the husband owned his business until he was adjudicated of unsound mind and that his wife carried on the business for him as agent or employee until such time. Accordingly, it is held that the business income reported on the return by the wife for the husband constitutes self-employment income to the husband within the meaning of section 1402(b) of the Code. It is further concluded that subsequent to being adjudicated of unsound mind, the husband was the beneficiary of an estate which consisted of property which he had previously owned legally. The income derived from the business during this period does not constitute self-employment income to the husband.

PART III.—INFORMATION RETURNS

SUBPART A.—INFORMATION CONCERNING PERSONS SUBJECT TO SPECIAL PROVISIONS

SECTION 6033.—RETURNS BY EXEMPT ORGANIZATIONS

Rev. Rul. 56–133

A student government association, which is an integral part of and controlled by a university exempt from Federal income tax as an educational organization under section 501(c)(3) of the Internal Revenue Code of 1954, is not required annually to file Form 990–A, U. S. Return of Organization Exempt from Tax.

Advice has been requested whether a student government association which is an integral part of and controlled by a university is required annually to file Form 990–A, U. S. Return of Organization Exempt from Tax.

The instant association was organized by the students of a university, exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 as an educational organization, for the purpose of self-government, the promotion of a clear and continuous exchange of ideas and opinions between the students and the administration, and the assumption of the fullest responsibilities and powers of self-government. Students automatically become members

of the association upon entering the university. The association's expenditures are approved by appropriate officers of the university and it is an integral part of and controlled by the university.

Among the organizations qualifying for exemption under section 501(c)(3) of the Internal Revenue Code of 1954 which are not required annually to file Form 990–A, U. S. Return of Organization Exempt from Tax, are educational organizations which normally maintain a regular faculty and curriculum and normally have a regularly organized body of pupils or students in attendance at the place where its activities are regularly carried on.

Accordingly, it is held that a student government association, which is an integral part of and controlled by a university exempt from Federal income tax as an educational organization under section 501(c)(3) of the Internal Revenue Code of 1954, is not required to file an annual return, Form 990–A, U. S. Return of Organization Exempt from Tax.

SUBPART B.—INFORMATION CONCERNING TRANSACTIONS WITH OTHER PERSONS

SECTION 6041.—INFORMATION AT SOURCE

Rev. Rul. 56–46

Payments of salaries or wages of $600 or more during a taxable year to a domestic or household employee by a housewife are not considered payments made in the course of a trade or business. Accordingly, the provisions of section 6041 of the Internal Revenue Code of 1954 requiring a taxpayer to file information returns (Forms 1096 and 1099) are not applicable with respect to payments made by a housewife to a domestic or household employee. However, the provisions of section 6041 of the Code are applicable with respect to payments made to a domestic or household employee with respect to services rendered in a home used in the operation of a trade or business, such as a rooming house, tourist home, etc.

Rev. Rul. 56–176

Even though an organization qualifies for Federal income tax exemption as an organization referred to in section 401(a), 501(c), or 501(d) of the Internal Revenue Code of 1954, it is nevertheless required to report payments of income specified in section 6041(a) of the Code. Accordingly, such organizations are required to file annual information returns on Form 1096, U. S. Annual Information Return, accompanied by statements on Form 1099, U. S. Information Return for calendar year ——, setting forth the name and address of each recipient and the amount of such payments made during a calendar year which total $600 or more. Such returns and statements are required by the regulations under section 147 of the Internal Revenue Code of 1939 which are made applicable to section 6041 of the 1954 Code by Treasury Decision 6091, C. B. 1954–2, 47.

SUBPART C.—INFORMATION REGARDING WAGES PAID EMPLOYEES

SECTION 6051.—RECEIPTS FOR EMPLOYEES

26 CFR 31.6051–1: Statements for employees.

Regulations under the 1954 Code with respect to withholding of income tax on amounts paid to employees after December 31, 1955, under wage continuation plans. See T. D. 6155, page 493.

SUBCHAPTER B.—MISCELLANEOUS PROVISIONS

SECTION 6103.—PUBLICITY OF RETURNS AND LISTS OF TAXPAYERS

26 CFR 301.6103(a)–100: Inspection by Department of Health, Education, and Welfare of individual income tax returns made under the Internal Revenue Code of 1954.

Inspection of returns by Department of Health, Education, and Welfare. See Rev. Proc. 56–6, page 1022.

CHAPTER 64.—COLLECTION

SUBCHAPTER C.—LIEN FOR TAXES

SECTION 6321.—LIEN FOR TAXES

26 CFR 301.6321–1: Lien for taxes. Rev. Rul. 56–48

Where an insurance company does not have actual notice or knowledge of the existence of a Federal tax lien (as distinguished from constructive notice given by the filing of a notice of lien as prescribed in the Internal Revenue Code of 1954) and in the absence of negligence or fraud, the company will not incur liability to the Government in making payments to an insured or beneficiary, against whom a Federal tax lien is outstanding, to the extent of his interest in a life insurance contract. This ruling is equally applicable to so-called policy loans which are deemed in reality mere advances of sums due the insured, under decisions such as *Board of Assessors of the Parish of Orleans, The City of New Orleans* v. *New York Life Insurance Company*, 216 U. S. 517.

Where an insurance company does have actual notice or knowledge of the existence of a Federal tax lien against a beneficiary or insured, the principles under which adverse interests in or to property or rights to property are entitled to protection may be applicable. In such

cases, if the person against whom the lien is outstanding fails to take appropriate action to obtain its release, or to obtain a discharge of the property from the lien, the company may protect itself against the possibility of liability to the Government by notifying the District Director of Internal Revenue of the facts and requesting advice as to the action to be taken to enforce the lien, meanwhile withholding payment of the sum in question.

SECTION 6323.—VALIDITY AGAINST MORTGAGEES, PLEDGEES, PURCHASERS, AND JUDGMENT CREDITORS

26 CFR 301.6323–1: Validity of lien against mortgagees, pledgees, purchasers and judgment creditors. Rev. Rul. 56–41

An advance of money by a mortgagee under an "open-end mortgage" providing for subsequent loans to a mortgagor secured by the original mortgage does not have priority over an intervening recorded Federal tax lien.

Advice has been requested whether an advance of money by a mortgagee under an "open-end mortgage" subsequent to the original loan has priority over an intervening recorded Federal tax lien.

The "open-end mortgage" originated by certain loan companies is stated to be a mortgage with a future advance clause providing for increasing an existing mortgage debt. Any loan or advance made subsequent to the original loan is secured by the same mortgage.

Sections 6321 and 6322 of the Internal Revenue Code of 1954 provide that personal and real property of a delinquent taxpayer is subject to a lien in favor of the United States and that such lien arises at the time the assessment is made. Section 6323 of the Code provides that with respect to a mortgagee, pledgee, purchaser or judgment creditor, the tax lien to be effective must be recorded by the Secretary or his delegate. The only exception to this provision is contained in subsection (c) relating to securities.

It is well established that the power of the United States to collect taxes cannot be restricted or in any way regulated by state laws unless specifically provided for by Congress. Thus, a state law exempting certain property from attachment or execution has no application to a Federal tax lien which under the paramount Federal law is binding from the date of its recordation without actual notice of it, except in the case of securities.

In *United States* v. *Security Trust & Savings Bank of San Diego, Executor etc., et al.*, 340 U. S. 47, Ct. D. 1736, C. B. 1950–2, 151, it was held that a tax lien of the United States is prior in right to an attachment lien where the Federal tax lien was recorded subsequent to the date of the attachment lien but prior to the date the attaching creditor obtained judgment. In arriving at its decision, the Court concluded that the attachment lien was merely inchoate prior to a judgment, notwithstanding the fact that under California law the attachment created a lien from the date of the levy of the attachment. The Court pointed out that the effect of a lien in relation to a provision of Federal law

for the collection of debts owing the United States is always a Federal question. Hence, although a state court's classification of a lien as specific and perfected is entitled to weight, it is subject to reexamination by the courts. The doctrine of relation back, which by process of judicial reasoning merges the attachment lien in the judgment and relates the judgment lien back to the date of attachment, does not operate to destroy the realities of the situation. Thus, an attachment lien not having been reduced to a judgment constitutes a mere "caveat of a more perfect lien to come" and would not have precedence over a recorded Federal tax lien.

A similar conclusion was reached by the Court in *United States* v. *Waddill Holland & Flinn Inc. et al.*, 323 U. S. 353, Ct. D. 1624, C. B. 1945, 459, where it was held that a Federal claim had priority over a landlord's contingent lien for rent notwithstanding the fact that under Virginia law the landlord was given a fixed and specific lien which related back to the beginning of the tenancy.

In the case of an "open-end mortgage" which covers future advances, it is possible that no future advance may ever be made. Therefore, until such an advance is actually made, there can be no fixed and specific or perfected lien under Federal law as distinguished from a mere contingent lien or "caveat of a more perfect lien to come." Consequently, an intervening recorded Federal tax lien has priority over advances made subsequent to the date of such recording.

SECTION 6324.—SPECIAL LIENS FOR ESTATE AND GIFT TAXES

26 CFR 301.6324–1: Special liens for estate and gift taxes; personal liability of transferees and others. — Rev. Rul. 56–144

The surviving tenant of jointly owned or entirety property, which is included in a decedent's gross estate under section 2040 of the Internal Revenue Code of 1954, is personally liable under section 6324(a)(2) of the Code for the Federal estate tax (if not paid when due) to the extent of the value of such property at the time of the decedent's death. Any part of such property, which is transferred by the surviving tenant to a bona fide purchaser, mortgagee, or pledgee for an adequate and full consideration in money or money's worth, is divested of the Federal estate tax lien under section 6324 (a)(2) of the Code. However, a like lien shall then attach to all the property of such surviving tenant or spouse, except any part transferred to a bona fide purchaser, mortgagee, or pledgee for an adequate and full consideration in money or money's worth. As used herein, a "bona fide purchaser, mortgagee, or pledgee" is one who, in acquiring the particular property, deals at arm's length, as between strangers, and pays a full and adequate consideration in money or money's worth. This conclusion is not affected by the fact that a purchaser, mortgagee, or pledgee of property from a surviving tenant is presumed to have knowledge of the estate tax lien by reason of the recital of death of a joint tenant in the chain of title.

CHAPTER 65.—ABATEMENTS, CREDITS, AND REFUNDS

SECTION 6402.—AUTHORITY TO MAKE CREDITS OR REFUNDS

26 CFR 301.6402–1: Authority to make credits or refunds. Rev. Rul. 56–92

The amount of an overpayment of tax as returned in a joint return filed by husband and wife may be credited against the tax liability of either spouse for a prior year.

Advice has been requested whether an overpayment of tax in a joint return filed by husband and wife may be credited against the unpaid separate tax liability of the husband for the previous taxable year, for which he had filed a separate return.

Section 6402 of the Internal Revenue Code of 1954 provides as follows:

(a) GENERAL RULE.—In the case of any overpayment, the Secretary or his delegate, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall refund any balance to such person.

Section 6013 of the Internal Revenue Code provides that a husband and wife may jointly make a single return of income taxes. The same section provides that if a joint return is made the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several.

Thus, although for the purpose of computing the tax imposed upon the basis of a joint return filed by husband and wife the return is treated as the return of a single taxable unit, the liability of each spouse with respect to such tax is joint and several. Compare *George W. Schoenhut* v. *Commissioner*, 45 B. T. A. 812; *Halbert P. Gillette* v. *Commissioner*, 46 B. T. A. 573; *Louis H. Moore* v. *United States*, 37 Fed. Supp. 136, certiorari denied, 314 U. S. 619; *Henry W. Taft* v. *Helvering*, 311 U. S. 195, Ct. D. 1478, C. B. 1940–2, 218; *Helvering* v. *Walter C. Janney, et al.*, 311 U. S. 189, Ct. D. 1479, C. B. 1940–2, 220. Accordingly, in the event of an overpayment of the tax as returned and paid by husband and wife pursuant to their joint and several liability, both the husband and the wife, jointly and severally, represent the person who made the overpayment within the meaning of section 6402, *supra*, and therefore the amount thereof may be credited against the separate tax liability of either the husband or the wife for a prior year.

26 CFR 301.6402–2: Claims for credit or refund. Rev. Rul. 56–297

It is the policy of the Internal Revenue Service to adjust self-employment tax liabilities on the basis of information contained in Form OAR–7000, Notice of Determination of Self-Employment Income, furnished by the Social Security Administration in connection with examinations made by that agency where claims for benefits are filed, and to refund overpaid self-employment taxes without requiring taxpayers

to file a claim on Form 843, Claim, provided such form can be processed before the expiration of the statutory period of limitations. Although the Commissioner in these cases may have before him information showing the grounds upon which a taxpayer's right to the allowance of a refund of self-employment tax rests, it is the position of the Service that Form OAR–7000 (or Form OAR–7010 when used by the Social Security Administration for self-employment purposes) cannot be considered a claim for refund or credit for overpaid taxes because such form does not meet the basic requirements of a claim as prescribed by the Internal Revenue Code and the regulations thereunder. Therefore, in cases where the self-employment tax has been overpaid, the taxpayer should file a claim for refund (Form 843) prior to the expiration of the statutory period of limitations.

CHAPTER 66.—LIMITATIONS

SUBCHAPTER A.—LIMITATIONS ON ASSESSMENT AND COLLECTION

SECTION 6501.—LIMITATIONS ON ASSESSMENT AND COLLECTION

26 CFR 301.6501(a): Statutory provisions; limitations on assessment and collection; general rule. T. D. 6172[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER F, PART 301.—PROCEDURE AND ADMINISTRATION

Regulations under chapter 66 of the Internal Revenue Code of 1954, relating to limitations.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

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[1] 21 F. R. 2919.

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AUTHORITY: §§ 301.6501(a) to 301.6533, incl., and 301.7851, issued under sec. 7805, I. R. C. 1954; 68A Stat. 917; 26 U. S. C. 7805.

On July 29, 1955, notice of proposed rulemaking regarding the regulations under chapter 66 of the Internal Revenue Code of 1954, relating to limitations applicable to the taxes imposed by such Code, was published in the Federal Register (20 F. R. 5423). After consideration of such relevant suggestions as were presented by interested persons regarding the proposals, the following regulations are hereby adopted:

LIMITATIONS

Limitations on Assessment and Collection

§ 301.6501(a) STATUTORY PROVISIONS; LIMITATIONS ON ASSESSMENT AND COLLECTION; GENERAL RULE.

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

(a) GENERAL RULE.—Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, within 3 years after such tax became due, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

§301.6501(a)–1 PERIOD OF LIMITATIONS UPON ASSESSMENT AND COLLECTION.—(a) The amount of any tax imposed by the Internal Revenue Code of 1954 (other than a tax collected by means of stamps) shall be assessed within 3 years after the return was filed. For rules

applicable in cases where the return is filed prior to the due date thereof, see section 6501(b). In the case of taxes payable by stamp, assessment must be made within 3 years after the tax became due. For exceptions and additional rules, see subsections (b) to (g) of section 6501, and for cross references to other provisions relating to limitations on assessment and collection, see sections 6501(h) and 6504.

(b) No proceeding in court without assessment for the collection of any tax shall be begun after the expiration of the applicable period for the assessment of such tax.

§ 301.6501(b) STATUTORY PROVISIONS; LIMITATIONS ON ASSESSMENT AND COLLECTION; TIME RETURN DEEMED FILED.

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION. * * *

(b) TIME RETURN DEEMED FILED.—

(1) EARLY RETURN.—For purposes of this section, a return of tax imposed by this title, except tax imposed by chapter 21 or 24, filed before the last day prescribed by law or by regulations promulgated pursuant to law for the filing thereof, shall be considered as filed on such last day.

(2) RETURN OF CERTAIN EMPLOYMENT TAXES.—For purposes of this section, if a return of tax imposed by chapter 21 or 24 for any period ending with or within a calendar year is filed before April 15 of the succeeding calendar year, such return shall be considered filed on April 15 of such calendar year.

(3) RETURN EXECUTED BY SECRETARY.—Notwithstanding the provisions of paragraph (2) of section 6020(b), the execution of a return by the Secretary or his delegate pursuant to the authority conferred by such section shall not start the running of the period of limitations on assessment and collection.

§ 301.6501(b)–1 TIME RETURN DEEMED FILED FOR PURPOSES OF DETERMINING LIMITATIONS.—(a) *Early return.*—Any return, other than employment tax returns referred to in paragraph (b) of this section, filed prior to the last day prescribed by law or regulations for the filing thereof (determined without regard to any extension of time for filing) shall be considered as filed on such last day.

(b) *Return of social security tax and of income tax withholding.*—If a return of tax under chapter 21 (relating to the Federal Insurance Contributions Act) or chapter 24 (relating to the collection of income tax at source on wages) for any period ending with or within a calendar year is filed before April 15 of the succeeding calendar year, such return shall be deemed filed on April 15 of such succeeding calendar year. For example, if quarterly returns are filed for the four quarters of 1955 on April 30, July 31, and October 31, 1955, and on January 31, 1956, the period of limitation for assessment with respect to the tax required to be reported on such returns is measured from April 15, 1956. However, if any of such returns is filed after April 15, 1956, the period of limitation for assessment of the tax required to be reported on that return is measured from the date it is in fact filed.

(c) *Returns executed by district directors or other internal revenue officers.*—The execution of a return by a district director or other authorized internal revenue officer or employee under the authority of section 6020(b) shall not start the running of the statutory period of limitations on assessment and collection.

§ 301.6501(c) STATUTORY PROVISIONS; LIMITATIONS ON ASSESSMENT AND COLLECTION; EXCEPTIONS.

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION. * * *

(c) EXCEPTIONS.—

(1) FALSE RETURN.—In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

(2) WILLFUL ATTEMPT TO EVADE TAX.—In case of a willful attempt in any manner to defeat or evade tax imposed by this title (other than tax imposed by subtitle A or B), the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

(3) NO RETURN.—In the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

(4) EXTENSION BY AGREEMENT.—Where, before the expiration of the time prescribed in this section for the assessment of any tax imposed by this title, except the estate tax provided in chapter 11, both the Secretary or his delegate and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

(5) TAX RESULTING FROM CHANGES IN CERTAIN INCOME TAX OR ESTATE TAX CREDITS.—

For special rules applicable in cases where the adjustment of certain taxes allowed as a credit against income taxes or estate taxes results in additional tax, see section 905(c) (relating to the foreign tax credit for income tax purposes) and section 2016 (relating to taxes of foreign countries, States, etc., claimed as credit against estate taxes).

§ 301.6501(c)-1 EXCEPTIONS TO GENERAL PERIOD OF LIMITATIONS ON ASSESSMENT AND COLLECTION.—(a) *False return.*—In the case of a false or fraudulent return with intent to evade any tax, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time after such false or fradulent return is filed.

(b) *Willful attempt to evade tax.*—In the case of a willful attempt in any manner to defeat or evade any tax imposed by the Internal Revenue Code of 1954 (other than a tax imposed by subtitle A or B, relating to income, estate, or gift taxes), the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

(c) *No return.*—In the case of a failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time after the date prescribed for filing the return.

(d) *Extension by agreement.*—The time prescribed by section 6501 for the assessment of any tax (other than the estate tax imposed by chapter 11) may, prior to the expiration of such time, be extended for any period of time agreed upon in writing by the taxpayer and the district director or any assistant regional commissioner. The extension shall become effective when the agreement has been executed by both parties. The period agreed upon may be extended by subse-

quent agreements in writing made before the expiration of the period previously agreed upon.

§ 301.6501(d) STATUTORY PROVISIONS; LIMITATIONS ON ASSESSMENT AND COLLECTION; REQUEST FOR PROMPT ASSESSMENT.

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

* * *

(d) REQUEST FOR PROMPT ASSESSMENT.—Except as otherwise provided in subsection (c), in the case of any tax (other than the tax imposed by chapter 11 of subtitle B, relating to estate taxes) for which return is required in the case of a decedent, or by his estate during the period of administration, or by a corporation, the tax shall be assessed, and any proceeding in court without assessment for the collection of such tax shall be begun, within 18 months after written request therefor (filed after the return is made and filed in such manner and such form as may be prescribed by regulations of the Secretary or his delegate) by the executor, administrator, or other fiduciary representing the estate of such decedent, or by the corporation, but not after the expiration of 3 years after the return was filed. This subsection shall not apply in the case of a corporation unless—

(1) Such written request notifies the Secretary or his delegate that the corporation contemplates dissolution at or before the expiration of such 18-month period; and

(2) The dissolution is in good faith begun before the expiration of such 18-month period; and

(3) The dissolution is completed.

§ 301.6501(d)-1 REQUEST FOR PROMPT ASSESSMENT.—(a) Except as otherwise provided in section 6501 (c) or (e), any tax for which a return is required and for which—

(1) A decedent or an estate of a decedent may be liable, other than the estate tax imposed by chapter 11, or

(2) A corporation which either has been dissolved, or is contemplating dissolution, may be liable,

shall be assessed, or a proceeding in court without assessment for the collection of such tax shall be begun, within 18 months after the receipt of a written request for prompt assessment thereof.

(b) The executor, administrator, or other fiduciary representing the estate of the decedent, or the corporation, or the fiduciary representing the dissolved corporation, as the case may be, shall, after the return in question has been filed, file the request for prompt assessment in writing with the district director for the internal revenue district in which such return was filed. The request, in order to be effective, must be transmitted separately from any other document, must set forth the classes of tax and the taxable periods for which the prompt assessment is requested, and must clearly indicate that it is a request for prompt assessment under the provisions of section 6501(d). The effect of such a request is to limit the time in which an assessment of tax may be made, or a proceeding in court without assessment for collection of tax may be begun, to a period of 18 months from the date the request is filed with the proper district director. The request does not extend the time within which an assessment may be made, or a proceeding in court without assessment may be begun, beyond 3 years from the date the return was filed. This special period of limitations will not apply to any return filed after a request for prompt assessment has been made unless an additional request is filed in the manner provided herein.

(c) In the case of a corporation the 18-month period shall not apply unless—

(1) The written request notifies the district director that the corporation either has been dissolved or contemplates dissolution at or before the expiration of such period, and

(2) In the case of a corporation contemplating dissolution—

(i) The dissolution is in good faith begun before the expiration of such 18-month period, and

(ii) The dissolution so begun is completed either before or after the expiration of such period.

§ 301.6501(e) STATUTORY PROVISIONS; LIMITATIONS ON ASSESSMENT AND COLLECTION; OMISSION FROM GROSS INCOME.

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION. * * *

(e) OMISSION FROM GROSS INCOME.—Except as otherwise provided in subsection (c)—

(1) INCOME TAXES.—In the case of any tax imposed by subtitle A—

(A) GENERAL RULES.—If the taxpayer omits from gross income and amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—

(i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) In determining the amount omitted from gross income, there shall not be taken into acount any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

(B) CONSTRUCTIVE DIVIDENDS.—If the taxpayer omits from gross income an amount properly includible therein under section 551 (b) (relating to the inclusion in the gross income of United States shareholders of their distributive shares of the undistributed foreign personal holding company income), the tax may be assessed, or a proceeding in court for the collectiontion of such tax may be begun without assessment, at any time within 6 years after the return was filed.

(2) ESTATE AND GIFT TAXES.—In the case of a return of estate tax under chapter 11 or a return of gift tax under chapter 12, if the taxpayer omits from the gross estate or from the total amount of the gifts made during the year items includible in such gross estate or such total gifts, as the case may be, as exceed in amount 25 percent of the gross estate stated in the return or the total amount of gifts stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. In determining the items omitted from the gross estate or the total gifts, there shall not be taken into account any item which is omitted from the gross estate or from the total gifts stated in the return if such item is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

§ 301.6501(e)-1 OMISSION FROM RETURN.—(a) *Income taxes.*—(1) *General rule.*—(i) If the taxpayer omits from the gross income stated in the return of a tax imposed by subtitle A an amount properly includible therein which is in excess of 25 percent of the gross income so stated, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.

(ii) For purposes of this subparagraph, the term "gross income," as it relates to a trade or business, means the total of the amounts received or accrued from the sale of goods or services, to the extent required to be shown on the return, without reduction for the cost of such sales or services. An item shall not be considered as omitted from gross income if information, sufficient to apprise the district director of the nature and amount of such item, is disclosed in the return or in any schedule or statement attached to the return.

(2) *Constructive dividends.*—If a taxpayer omits from gross income an amount properly includible therein under section 551(b) as his distributive share of the undistributed foreign personal holding company income, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.

(b) *Estate and gift taxes.*—(1) If the taxpayer omits from the gross estate as stated in the estate tax return, or from the total amount of the gifts made during the year as stated in the gift tax return, an item or items properly includible therein the amount of which is in excess of 25 percent of the gross estate as stated in the return, or 25 percent of the total amount of the gifts as stated in the return, the tax may be assessed, or a proceeding in court for the collection thereof may be begun without assessment, at any time within 6 years after the return was filed.

(2) For purposes of this paragraph, an item disclosed in the return or in any schedule or statement attached to the return in a manner sufficient to apprise the District Director of the nature and amount thereof shall not be taken into acount in determining items omitted from the gross estate or total gifts, as the case may be. Further, there shall not be taken into account in computing the 25 percent omission from the gross estate stated in the estate tax return or from the total gifts stated in the gift tax return, any increases in the valuation of assets disclosed on the return.

(c) *Exception.*—The provisions of this section do not limit the application of section 6501(c).

§ 301.6501(f) STATUTORY PROVISIONS; LIMITATIONS ON ASSESSMENT AND COLLECTION; PERSONAL HOLDING COMPANY TAX.

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION. * * *

(f) PERSONAL HOLDING COMPANY TAX.—If a corporation which is a personal holding company for any taxable year fails to file with its return under chapter 1 for such a year a schedule setting forth—

(1) the items of gross income, described in section 543(a), received by the corporation during such year, and

(2) the names and addresses of the individuals who owned, within the meaning of section 544 (relating to rules for determining stock ownership), at any time during the last half of such year more than 50 percent in value of the outstanding capital stock of the corporation,

the personal holding company tax for such year may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return for such year was filed.

§ 301.6501(f)-1 PERSONAL HOLDING COMPANY TAX.—If a corporation which is a personal holding company for any taxable year fails to file with its income tax return for such year a schedule setting forth the items of gross income described in section 543(a) received by the corporation during such year, and the names and addresses of the individuals who owned, within the meaning of section 544, at any time during the last half of such taxable year, more than 50 percent in value of the outstanding capital stock of the corporation, the personal holding company tax for such year may be assessed, or a proceeding in court for the collection thereof may be begun without assessment, at any time within 6 years after the return for such year was filed.

§ 301.6501(g) STATUTORY PROVISIONS; LIMITATIONS ON ASSESSMENT AND COLLECTION; CERTAIN INCOME TAX RETURNS OF CORPORATIONS.

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION. * * *

(g) CERTAIN INCOME TAX RETURNS OF CORPORATIONS.—

(1) TRUSTS OR PARTNERSHIPS.—If a taxpayer determines in good faith that it is a trust or partnership and files a return as such under subtitle A, and if such taxpayer is thereafter held to be a corporation for the taxable year for which the return is filed, such return shall be deemed the return of the corporation for purposes of this section.

(2) EXEMPT ORGANIZATIONS.—If a taxpayer determines in good faith that it is an exempt organization and files a return as such under section 6033, and if such taxpayer is thereafter held to be a taxable corporation for the taxable year for which the return is filed, such return shall be deemed the return of the corporation for purposes of this section.

§ 301.6501(g)-1 CERTAIN INCOME TAX RETURNS OF CORPORATIONS.—(a) *Trusts or partnerships.*—If a taxpayer determines in good faith that it is a trust or partnership and files a return as such under subtitle A, and if the taxpayer is later held to be a corporation for the taxable year for which the return was filed, such return shall be deemed to be the return of the corporation for the purpose of section 6501.

(b) *Exempt organizations.*—If a taxpayer determines in good faith that it is an exempt organization and files a return as such under section 6033, and if the taxpayer is later held to be a taxable organization for the taxable year for which the return was filed, such return shall be deemed to be the return of the organization for the purpose of section 6501.

§ 301.6501(h) STATUTORY PROVISIONS; LIMITATIONS ON ASSESSMENT AND COLLECTION; JOINT INCOME RETURN AFTER SEPARATE RETURN.

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION. * * *

(h) JOINT INCOME RETURN AFTER SEPARATE RETURN.—

For period of limitations for assessment and collection in the case of a joint income return filed after separate returns have been filed, see section 6013(b)(3) and (4).

§ 301.6502 Statutory Provisions; Collection After Assessment.

SEC. 6502. COLLECTION AFTER ASSESSMENT.

(a) Length of Period.—Where the assessment of any tax imposed by this title has been made within the period of limitation properly applicable thereto, such tax may be collected by levy or by a proceeding in court, but only if the levy is made or the proceeding begun—

(1) within 6 years after the assessment of the tax, or

(2) prior to the expiration of any period for collection agreed upon in writing by the Secretary or his delegate and the taxpayer before the expiration of such 6-year period (or, if there is a release of levy under section 6343 after such 6-year period, then before such release).

The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

(b) Date When Levy Is Considered Made.—The date on which a levy on property or rights to property is made shall be the date on which the notice of seizure provided in section 6335(a) is given.

§ 301.6502–1 Collection After Assessment.—(a) *Length of period.*—(1) *General rule.*—In any case in which a tax has been assessed within the statutory period of limitation properly applicable thereto, a proceeding in court to collect such tax may be begun, or levy for the collection of such tax may be made, within 6 years after the assessment thereof.

(2) *Extension by agreement.*—(i) The 6-year period of limitation on collection after assessment of any tax may, prior to the expiration thereof, be extended for any period of time agreed upon in writing by the taxpayer and the district director. The extension shall become effective upon execution of the agreement by both the taxpayer and the district director.

(ii) The period of limitation on collection after assessment of any tax (including any extension of such period) may be extended after the expiration thereof if there has been a levy on any part of the taxpayer's property prior to such expiration and if the extension is agreed upon in writing prior to a release of the levy under the provisions of section 6343. An extension under this subdivision has the same effect as an agreement made prior to the expiration of the period of limitation on collection after assessment, and during the period of the extension collection may be enforced as to all property or rights to property owned by the taxpayer whether or not seized under the levy which was released.

(iii) Any period agreed upon under the provisions of this subparagraph may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

(b) *Date when levy is considered made.*—The date on which a levy on property or rights to property is made is the date on which the notice of seizure provided in section 6335(a) is given.

§ 301.6503(a) Statutory Provisions; Suspension of Running of Period of Limitation; Issuance of Statutory Notice of Deficiency.

SEC. 6503. SUSPENSION OF RUNNING OF PERIOD OF LIMITATION.

(a) Issuance of Statutory Notice of Deficiency.—

(1) General rule.—The running of the period of limitations provided in section 6501 or 6502 on the making of assessments or the collection by levy or a proceeding in court, in respect of any defi-

ciency as defined in section 6211 (relating to income, estate, and gift taxes), shall (after the mailing of a notice under section 6212(a)) be suspended for the period during which the Secretary or his delegate is prohibited from making the assessment or from collecting by levy or a proceeding in court (and in any event, if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, until the decision of the Tax Court becomes final), and for 60 days thereafter.

(2) CORPORATION JOINING IN CONSOLIDATED INCOME TAX RETURN.—If a notice under section 6212(a) in respect of a deficiency in tax imposed by subtitle A for any taxable year is mailed to a corporation, the suspension of the running of the period of limitations provided in paragraph (1) of this subsection shall apply in the case of corporations with which such corporation made a consolidated income tax return for such taxable year.

§ 301.6503(a)–1. SUSPENSION OF RUNNING OF PERIOD OF LIMITATION; ISSUANCE OF STATUTORY NOTICE OF DEFICIENCY.—(a) *General rule.*—Upon the mailing of a notice of deficiency for income, estate, or gift tax under the provisions of section 6212, the period of limitation on assessment and collection of any deficiency is suspended for 90 days if the notice of delinquency is addressed to a person within the States of the Union and the District of Columbia, or 150 days if such notice is addressed to a person outside the States of the Union and the District of Columbia (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the 90th or 150th day), plus and additional 60 days thereafter in either case. If a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations is suspended until the decision of the Tax Court becomes final, and for an additional 60 days thereafter. If a notice of deficiency is mailed to a taxpayer within the period of limitation and the taxpayer does not appeal therefrom to the Tax Court, the notice of deficiency so given does not suspend the running of the period of limitation with respect to any additional deficiency shown to be due in a subsequent deficiency notice.

Example. A taxpayer filed a return for the calendar year 1954 on April 15, 1955; the notice of deficiency was mailed to him (at an address within the United States) on April 15, 1958; and he filed a petition with the Tax Court on July 14, 1958. The decision of the Tax Court became final on November 6, 1959. The running of the period of limitation for assessment is suspended from April 15, 1958 to January 5, 1960, which date is 60 days after the date (November 6, 1959) on which the decision became final. If in this example the taxpayer had failed to file a petition with the Tax Court, the running of the period of limitation for assessment would then be suspended from April 15, 1958 (the date of notice), to September 12, 1958 (that is, for the 90-day period in which he could file a petition with the Tax Court, and for 60 days thereafter).

(b) *Corporations joining in consolidated return.*—If a notice under section 6212(a) with respect to a deficiency in tax imposed by subtitle A for any taxable year is mailed to a corporation, the suspension of the running of the period of limitations provided in section 6503(a)(1) shall apply in the case of corporations with which such corporation made a consolidated income tax return for such taxable year. Under § 1.1502–16 of the Income Tax Regulations (relating to consolidated returns), notices of deficiency are mailed only to the common parent.

§ 301.6503(b) STATUTORY PROVISIONS; SUSPENSION OF RUNNING OF PERIOD OF LIMITATION; ASSETS OF TAXPAYER IN CONTROL OR CUSTODY OF COURT.

SEC. 6503. SUSPENSION OF RUNNING OF PERIOD OF LIMITATION. * * *

(b) ASSETS OF TAXPAYER IN CONTROL OR CUSTODY OF COURT.—The period of limitations on collection after assessment prescribed in section 6502 shall be suspended for the period the assets of the taxpayer (other than the estate of a decedent or of an incompetent) are in the control or custody of the court in any proceeding before any court of the United States or of any State or Territory or of the District of Columbia, and for 6 months thereafter.

§ 301.6503(b)-1 SUSPENSION OF RUNNING OF PERIOD OF LIMITATION; ASSETS OF TAXPAYER IN CONTROL OR CUSTODY OF COURT.—Where the assets of a taxpayer (other than the estate of a decedent or of an incompetent) are in the control or custody of the court in any proceeding before any court of the United States or of any State or Territory of the United States or of the District Columbia, the period of limitation on collection after assessment prescribed in section 6502 is suspended for the period such assets are in the control or custody of the court, and for 6 months thereafter.

§ 301.6503(c) STATUTORY PROVISIONS; SUSPENSION OF RUNNING OF PERIOD OF LIMITATION; LOCATION OF PROPERTY OUTSIDE THE UNITED STATES OR REMOVAL OF PROPERTY FROM THE UNITED STATES.

SEC. 6503. SUSPENSION OF RUNNING OF PERIOD OF LIMITATION. * * *

(c) LOCATION OF PROPERTY OUTSIDE THE UNITED STATES OR REMOVAL OF PROPERTY FROM THE UNITED STATES.—In case collection is hindered or delayed because property of the taxpayer is situated or held outside the United States or is removed from the United States, the period of limitations on collection after assessment prescribed in section 6502 shall be suspended for the period collection is so hindered or delayed. The total suspension of time under this subsection shall not in the aggregate exceed 6 years.

§ 301.6503(c)-1 SUSPENSION OF RUNNING OF PERIOD OF LIMITATION; LOCATION OF PROPERTY OUTSIDE THE UNITED STATES OR REMOVAL OF PROPERTY FROM THE UNITED STATES.—The running of the period of limitation on collection after assessment prescribed in section 6502 is suspended for the period of time that collection is hindered or delayed because property of the taxpayer is situated or held outside the United States or is removed from the United States. The total suspension of time under this provision shall not in the aggregate exceed 6 years. In any case in which the district director determines that collection is so hindered or delayed, he shall make and retain in the files of his office a written report which shall identify the taxpayer and the tax liability, shall show what steps were taken to collect the tax liability, shall state the grounds for his determination that property of the taxpayer is situated or held outside, or is removed from, the United States, and shall show the date on which it was first determined that collection was so hindered or delayed. The term "property" includes all property or rights to property, real or personal, tangible or intangible, belonging to the taxpayer. The suspension of the running of the period of limitation on collection

shall be considered to begin on the date so determined by the district director. A copy of the report shall be mailed to the taxpayer at his last known address.

§ 301.6503(d) STATUTORY PROVISIONS; SUSPENSION OF RUNNING OF PERIOD OF LIMITATION; EXTENSIONS OF TIME FOR PAYMENT OF ESTATE TAX.

SEC. 6503. SUSPENSION OF RUNNING OF PERIOD OF LIMITATION. * * *

(d) EXTENSIONS OF TIME FOR PAYMENT OF ESTATE TAX.—The running of the period of limitations for assessment or collection of any tax imposed by chapter 11 shall be suspended for the period of any extension of time for payment granted under the provisions of section 6161 (a)(2) or (b)(2).

§ 301.6503(d)-1 SUSPENSION OF RUNNING OF PERIOD OF LIMITATION; EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX.—Where an estate is granted an extension of time as provided in section 6161 (a)(2) or (b)(2) for payment of any estate tax, the running of the period of limitations for assessment or collection of such tax is suspended for the period of time for which the extension is granted.

§ 301.6503(e) STATUTORY PROVISIONS; SUSPENSION OF RUNNING OF PERIOD OF LIMITATION; CROSS REFERENCES.

SEC. 6503. SUSPENSION OF RUNNING OF PERIOD OF LIMITATION. * * *

(e) CROSS REFERENCES.—

For suspension in case of—
(1) Deficiency dividends of a personal holding company, see section 547(f).
(2) Bankruptcy and receiverships, see subchapter B of chapter 70.
(3) Claims against transferees and fiduciaries, see chapter 71.

§ 301.6504 STATUTORY PROVISIONS; CROSS REFERENCES.

SEC. 6504. CROSS REFERENCES.

For limitation period in case of—
(1) Adjustments incident to involuntary liquidation of inventory, see section 1321.
(2) Adjustments to accrued foreign taxes, see section 905(c).
(3) Change of election to take standard deduction where taxpayer and his spouse make separate returns, see section 144(b).
(4) Involuntary conversion of property, see section 1033(a)(3)(C) and (D).
(5) Gain upon sale or exchange of residence, see section 1034(j).
(6) War loss recoveries where prior benefit rule is elected, see section 1335.
(7) Recovery of unconstitutional Federal taxes, see section 1346.
(8) Limitations on deductions allowable to individuals in certain cases, see section 270(d).
(9) Application by executor for discharge from personal liability for estate tax, see section 2204.
(10) Insolvent banks and trust companies, see section 7507.
(11) Service in a combat zone, etc., see section 7508.
(12) Claims against transferees and fiduciaries, see chapter 71.

Limitations on Credit or Refund

§ 301.6511(a) STATUTORY PROVISIONS; LIMITATIONS ON CREDIT OR REFUND; PERIOD OF LIMITATION ON FILING CLAIM.

SEC. 6511. LIMITATIONS ON CREDIT OR REFUND.

(a) PERIOD OF LIMITATION ON FILING CLAIM.—Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was required to be filed (determined without regard to any extension of time) or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid. Claim for credit or refund of an overpayment

of any tax imposed by this title which is required to be paid by means of a stamp shall be filed by the taxpayer within 3 years from the time the tax was paid.

§ 301.6511(a)-1 *Period of limitation on filing claim.*—(a) In the case of any tax (other than a tax payable by stamp)—

(1) If a return is filed, a claim for credit or refund of an overpayment must be filed by the taxpayer within 3 years from the last date prescribed for the filing of the return (determined without regard to any extension of time for filing such return) or within 2 years from the time the tax was paid, whichever of such periods expires the later.

(2) If no return is filed, the claim for credit or refund of an overpayment must be filed by the taxpayer within 2 years from the time the tax was paid.

(b) In the case of any tax payable by means of a stamp, a claim for credit or refund of an overpayment of such tax must be filed by the taxpayer within 3 years from the time the tax was paid. For provisions relating to redemption of unused stamps, see section 6805.

(c) For limitations on allowance of credit or refund, special rules, and exceptions, see subsections (b) through (e) of section 6511. For limitations in the case of a petition to the Tax Court, see section 6512. For rules as to time return is deemed filed and tax considered paid, see section 6513.

§ 301.6511(b) STATUTORY PROVISIONS; LIMITATIONS ON CREDIT OR REFUND; LIMITATION ON ALLOWANCE OF CREDITS AND REFUNDS.

SEC. 6511. LIMITATIONS ON CREDIT OR REFUND. * * *

(b) LIMITATION ON ALLOWANCE OF CREDITS AND REFUNDS.—

(1) FILING OF CLAIM WITHIN PRESCRIBED PERIOD.—No credit or refund shall be allowed or made after the expiration of the period of limitation prescribed in subsection (a) for the filing of a claim for credit or refund, unless a claim for credit or refund is filed by the taxpayer within such period.

(2) LIMIT ON AMOUNT OF CREDIT OR REFUND.—

(A) LIMIT TO AMOUNT PAID WITHIN 3 YEARS.—If the claim was filed by the taxpayer during the 3-year period prescribed in subsection (a), the amount of the credit or refund shall not exceed the portion of the tax paid within the 3 years immediately preceding the filing of the claim. If the tax was required to be paid by means of a stamp, the amount of the credit or refund shall not exceed the portion of the tax paid within the 3 years immediately preceding the filing of the claim.

(B) LIMIT TO AMOUNT PAID WITHIN 2 YEARS.—If the claim was not filed within such 3-year period, the amount of the credit or refund shall not exceed the portion of the tax paid during the 2 years immediately preceding the filing of the claim.

(C) LIMIT IF NO CLAIM FILED.—If no claim was filed, the credit or refund shall not exceed the amount which would be allowable under subparagraph (A) or (B), as the case may be, if claim was filed on the date the credit or refund is allowed.

§ 301.6511(b)-1 LIMITATIONS ON ALLOWANCE OF CREDITS AND REFUNDS.—(a) *Effect of filing claim.*—Unless a claim for credit or refund of an overpayment is filed within the period of limitation prescribed in section 6511(a), no credit or refund shall be allowed or made after the expiration of such period.

(b) *Limit on amount to be credited or refunded.*—(1) In the case of any tax (other than a tax payable by stamp)—

(i) If a return was filed, and a claim is filed within 3 years from the last date prescribed for filing such return (determined without regard to any extension of time for such filing), the amount of the credit or refund shall not exceed the portion of the tax paid within the 3 years immediately preceding the filing of the claim.

(ii) If a return was filed, and a claim is filed after the 3-year period described in subdivision (i) of this subparagraph but within 2 years from the time the tax was paid, the amount of the credit or refund shall not exceed the portion of the tax paid within the 2 years immediately preceding the filing of the claim.

(iii) If no return was filed, but a claim is filed, the amount of the credit or refund shall not exceed the portion of the tax paid within the 2 years immediately preceding the filing of the claim.

(iv) If no claim is filed, the amount of the credit or refund allowed or made by the district director shall not exceed the amount that would have been allowable under the preceding subdivisions of this subparagraph if a claim had been filed on the date the credit or refund is allowed.

(2) In the case of a tax payable by stamp—

(i) If a claim is filed, the amount of the credit or refund shall not exceed the portion of the tax paid within the 3 years immediately preceding the filing of the claim.

(ii) If no claim is filed, the amount of the credit or refund allowed or made by the district director shall not exceed the portion of the tax paid within the 3 years immediately preceding the allowance of the credit or refund.

For provisions relating to redemption of unused stamps, see section 6805.

§ 301.6511(c) STATUTORY PROVISIONS; LIMITATIONS ON CREDIT OR REFUND; SPECIAL RULES APPLICABLE IN CASE OF EXTENSION OF TIME BY AGREEMENT

SEC. 6511. LIMITATIONS ON CREDIT OR REFUND. * * *

(c) SPECIAL RULES APPLICABLE IN CASE OF EXTENSION OF TIME BY AGREEMENT.—If an agreement under the provisions of section 6501 (c) (4) extending the period for assessment of a tax imposed by this title is made within the period prescribed in subsection (a) for the filing of a claim for credit or refund—

(1) TIME FOR FILING CLAIM.—The period for filing claim for credit or refund or for making credit or refund if no claim is filed, provided in subsections (a) and (b) (1), shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof under section 6501 (c) (4).

(2) LIMIT ON AMOUNT.—If a claim is filed, or a credit or refund is allowed when no claim was filed, after the execution of the agreement and within 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof, the amount of the credit or refund shall not exceed the portion of the tax paid after the execution of the agreement and before the filing of the claim or the making of the credit or refund, as the case may be, plus the portion of the tax paid within the period which would be applicable under subsection (b) (2) if a claim had been filed on the date the agreement was executed.

(3) CLAIMS NOT SUBJECT TO SPECIAL RULE.—This subsection shall not apply in the case of a claim filed, or credit or refund allowed if no claim is filed, either—

(A) prior to the execution of the agreement or

(B) more than 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof.

§ 301.6511(c)-1 SPECIAL RULES APPLICABLE IN CASE OF EXTENSION OF TIME BY AGREEMENT.—(a) *Scope.*—If, within the period prescribed in section 6511(a) for the filing of a claim for credit or refund, an agreement extending the period for assessment of a tax has been made in accordance with the provisions of section 6501(c)(4), the special rules provided in this section become applicable. This section shall not apply to any claim filed, or credit or refund allowed if no claim is filed, either (1) prior to the execution of an agreement extending the period in which assessment may be made, or (2) more than 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof.

(b) *Period in which claim may be filed.*—Claim for credit or refund of an overpayment may be filed, or credit or refund may be allowed if no claim is filed, at any time within which an assessment may be made pursuant to an agreement, or any extension thereof, under section 6501(c)(4), and for 6 months thereafter.

(c) *Limit on amount to be credited or refunded.*—(1) If a claim is filed within the time prescribed in paragraph (b) of this section, the amount of the credit or refund allowed or made shall not exceed the portion of the tax paid after the execution of the agreement and before the filing of the claim, plus the amount that could have been properly credited or refunded under the provisions of section 6511(b)(2) if a claim had been filed on the date of the execution of the agreement.

(2) If no claim is filed, the amount of credit or refund allowed or made within the time prescribed in paragraph (b) of this section shall not exceed the portion of the tax paid after the execution of the agreement and before the making of the credit or refund, plus the amount that could have been properly credited or refunded under the provisions of section 6511(b)(2) if a claim had been filed on the date of the execution of the agreement.

(d) *Effective date of agreement.*—The agreement referred to in this section shall become effective when signed by the taxpayer and the district director or an Assistant Regional Commissioner.

§ 301.6511(d) STATUTORY PROVISIONS; LIMITATIONS ON CREDIT OR REFUND; SPECIAL RULES APPLICABLE TO INCOME TAXES.

SEC. 6511. LIMITATIONS ON CREDIT OR REFUND. * * *

(d) SPECIAL RULES APPLICABLE TO INCOME TAXES.—

(1) SEVEN-YEAR PERIOD OF LIMITATION WITH RESPECT TO BAD DEBTS AND WORTHLESS SECURITIES.—If the claim for credit or refund relates to an overpayment of tax imposed by subtitle A on account of—

(A) The deductibility by the taxpayer, under section 166 or section 832(c), of a debt as a debt which became worthless, or, under section 165(g), of a loss from worthlessness of a security, or

(B) The effect that the deductibility of a debt or loss described in subparagraph (A) has on the application to the taxpayer of a carryover,

in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 7 years from the date prescribed by law for filing

the return for the year with respect to which the claim is made. If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carryback, the period shall be either 7 years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback or the period prescribed in paragraph (2) of this subsection, whichever expires the later. In the case of a claim described in this paragraph the amount of the credit or refund may exceed the portion of the tax paid within the period prescribed in subsection (b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in this paragraph.

(2) SPECIAL PERIOD OF LIMITATION WITH RESPECT TO NET OPERATING LOSS CARRYBACKS.—

(A) PERIOD OF LIMITATION.—If the claim for credit or refund relates to an overpayment attributable to a net operating loss carryback, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be that period which ends with the expiration of the 15th day of the 39th month following the end of the taxable year of the net operating loss which results in such carryback, or the period prescribed in subsection (c) in respect of such taxable year, whichever expires later. In the case of such a claim, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in subsection (b)(2) or (c), whichever is applicable, to the extent of the amount of the payment attributable to such carryback.

(B) APPLICABLE RULES.—If the allowance of a credit or refund of an overpayment of tax attributable to a net operating loss carryback is otherwise prevented by the operation of any law or rule of law other than section 7122, relating to compromises, such credit or refund may be allowed or made, if claim therefor is filed within the period provided in subparagraph (A) of this paragraph. If the allowance of an application, credit, or refund of a decrease in tax determined under section 6411(b) is otherwise prevented by the operation of any law or rule of law other than section 7122, such application, credit, or refund may be allowed or made if application for a tentative carryback adjustment is made within the period provided in section 6411(a). In the case of any such claim for credit or refund or any such application for a tentative carryback adjustment, the determination by any court, including the Tax Court, in any proceeding in which the decision of the court has become final, shall be conclusive except with respect to the net operating loss deduction, and the effect of such deduction, to the extent that such deduction is affected by a carryback which was not in issue in such proceeding.

(3) SPECIAL RULES RELATING TO FOREIGN TAX CREDIT.—

(A) SPECIAL PERIOD OF LIMITATION WITH RESPECT TO FOREIGN TAXES PAID OR ACCRUED.—If the claim for credit or refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country or to any possession of the United States for which credit is allowed against the tax imposed by subtitle A in accordance with the provisions of section 901 or the provisions of any treaty to which the United States is a party, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 10 years from the date prescribed by law for filing the return for the year with respect to which the claim is made.

(B) EXCEPTION IN THE CASE OF FOREIGN TAXES PAID OR ACCRUED.—In the case of a claim described in subparagraph (A), the amount of the credit or refund may exceed the portion of the tax paid within the period provided in subsection (b) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the allowance of a credit for the taxes described in subparagraph (A).

§ 301.6511(d)-1 Overpayment of Income Tax on Account of Bad Debts, Worthless Securities, Etc.—(a)(1) If the claim for credit or refund relates to an overpayment of income tax on account of—

(i) The deductibility by the taxpayer, under section 166 or section 832(c), of a debt as a debt which became worthless, or, under section 165(g), of a loss from the worthlessness of a security, or

(ii) The effect that the deductibility of a debt or loss described in subdivision (i) of this subparagraph has on the application to the taxpayer of a carryover,

then in lieu of the 3-year period from the last date prescribed for filing the return (determined without regard to any extension of time for filing such return), in which claim may be filed or credit or refund allowed, as prescribed in section 6511(a) or (b), the period shall be 7 years from the date prescribed by law for filing the return (determined without regard to any extension of time for filing such return) for the taxable year for which the claim is made or the credit or refund allowed or made.

(2) If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of a debt or loss, described in subparagraph (1) of this paragraph, has on the application to the taxpayer of a net operating loss carryback provided in section 172(b), the period in which claim for credit or refund may be filed shall be whichever of the following two periods expires later:

(i) Seven years from the last date prescribed for filing the return (determined without regard to any extension of time for filing such return) for the taxable year of the net operating loss which results in such carryback, or

(ii) The period which ends with the expiration of the period prescribed in section 6511(c) within which a claim for credit or refund may be filed with respect to the taxable year of the net operating loss which resulted in the carryback.

(3) In the case of a claim for credit or refund involving items described in this section, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in section 6511(b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the deductibility of items described in subparagraph (1) of this paragraph. If the claim involves an overpayment based not only on the deductibility of items described in subparagraph (1) of this paragraph but based also on other items, the credit or refund cannot exceed the sum of the following:

(i) The amount of the overpayment which is attributable to the deductibility of items described in subparagraph (1) of this paragraph, and

(ii) The balance of such overpayment up to a limit of the portion, if any, of the tax paid within the period provided in section 6511(b)(2) or (c), or within the period provided in any other applicable provision of law.

(4) If the claim involves an overpayment based not only on the deductibility of items described in subparagraph (1) of this paragraph but based also on other items, and if the claim with respect to any items is barred by the expiration of any applicable period of limitation, the portion of the overpayment attributable to the items not so barred

shall be determined by treating the allowance of such items as the first adjustment to be made in computing such overpayment.

(b) If a claim for credit or refund is not filed within the applicable period described in paragraph (a) of this section, then credit or refund may be allowed or made only if claim therefor is filed or if such credit or refund is allowed within any period prescribed in section 6511(a), (b), or (c), whichever is applicable, subject to the provisions thereof limiting the amount of credit or refund in the case of a claim filed, or, if no claim was filed, in the case of credit or refund allowed within such applicable period as prescribed in section 6511(b) or (c).

(c) The provisions of this section and section 6511(d)(1) do not apply to an overpayment resulting from the deductibility of a debt that became partially worthless during the taxable year, but only to an overpayment resulting from the deductibility of a debt which became entirely worthless during such year.

(d) The provisions of paragraph (a) of this section with regard to an overpayment caused by the deductibility of a bad debt under section 166 or section 832(c), or of a loss from the worthlessness of a security under section 165(g), are likewise applicable to an overpayment caused by the effect that the deductibility of such bad debt or loss has on the application to the taxpayer of a carryover or of a carryback.

§ 301.6511(d)-2 Overpayment of Income Tax on Account of Net Operating Loss Carrybacks.—(a) *Special period of limitation.*—(1) If the claim for credit or refund relates to an overpayment of income tax attributable to a net operating loss carryback, provided in section 172(b), then in lieu of the 3-year period from the last date prescribed for the filing of the return (determined without regard to any extension of time for filing such return) in which the claim may be filed or credit or refund allowed, as prescribed in section 6511 (a) or (b), the period shall be whichever of the following 2 periods expires later:

(i) The period which ends with the expiration of the fifteenth day of the thirty-ninth month following the end of the taxable year of the net operating loss which resulted in the carryback; or

(ii) The period which ends with the expiration of the period prescribed in section 6511(c) within which a claim for credit or refund may be filed with respect to the taxable year of the net operating loss which resulted in the carryback.

(2) In the case of a claim for credit or refund involving a net operating loss carryback described in subparagraph (1) of this paragraph, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in section 6511(b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the carryback. If the claim involves an overpayment based not only on a net operating loss carryback described in subparagraph (1) of this paragraph but based also on other items, the credit or refund cannot exceed the sum of the following:

(i) The amount of the overpayment which is attributable to the net operating loss carryback, and

(ii) The balance of such overpayment up to a limit of the portion, if any, of the tax paid within the period provided in section 6511 (b)(2) or (c), or within the period provided in any other applicable provision of law.

(3) If the claim involves an overpayment based not only on a net operating loss carryback described in subparagraph (1) of this paragraph but based also on other items, and if the claim with respect to any items is barred by the expiration of any applicable period of limitation, the portion of the overpayment attributable to the items not so barred shall be determined by treating the allowance of such items as the first adjustment to be made in computing such overpayment. If a claim for credit or refund is not filed, and if credit or refund is not allowed, within the period prescribed in this paragraph, then credit or refund may be allowed or made only if claim therefor is filed, or if such credit or refund is allowed, within the period prescribed in section 6511 (a), (b), or (c), whichever is applicable, subject to the provisions thereof limiting the amount of credit or refund in the case of a claim filed, or if no claim was filed, in case of credit or refund allowed, within such applicable period. For the limitations on the allowance of interest for an overpayment where credit or refund is subject to the provisions of this section, see section 6611(f).

(b) *Barred overpayments.*—If the allowance of a credit or refund of an overpayment of tax attributable to a net operating loss carryback is otherwise prevented by the operation of any law or rule of law (other than section 7122, relating to compromises), such credit or refund may be allowed or made under the provisions of section 6511(d)(2)(B) if a claim therefor is filed within the period provided by section 6511(d)(2)(A) and paragraph (a) of this section for filing a claim for credit or refund of an overpayment attributable to a carryback. Similarly, if the allowance of an application, credit, or refund of a decrease in tax determined under section 6411(b) is otherwise prevented by the operation of any law or rule of law (other than section 7122), such application, credit, or refund may be allowed or made if an application for a tentative carryback adjustment is filed within the period provided in section 6411(a). Thus, for example, even though the tax liability (not including the net operating loss deduction or the effect of such deduction) for a given taxable year has previously been litigated before the Tax Court, credit or refund of an overpayment may be allowed or made despite the provisions of section 6512(a), if claim for such credit or refund is filed within the period provided in section 6511(d)(2)(A) and paragraph (a) of this section. In the case of a claim for credit or refund of an overpayment attributable to a carryback, or in the case of an application for a tentative carryback adjustment, the determination of any court, including the Tax Court, in any proceeding in which the decision of the court has become final, shall be conclusive except with respect to the net operating loss deduction, and the effect of such deduction, to the extent that such deduction is affected by a carryback which was not in issue in such proceeding.

§ 301.6511(d)-3 Special Rules Applicable to Credit Against Income Tax for Foreign Taxes.—(a) *Period in which claim may be filed.*—In the case of an overpayment of income tax resulting from a

credit, allowed under the provisions of section 901 or under the provisions of any treaty to which the United States is a party, for taxes paid or accrued to a foreign country or possession of the United States, a claim for credit or refund must be filed by the taxpayer within 10 years from the last date prescribed for filing the return (determined without regard to any extension of time for filing such return) for the taxable year with respect to which the claim is made. Such 10-year period shall be applied in lieu of the 3-year period prescribed in section 6511(a).

(b) *Limit on amount to be credited or refunded.*—In the case of a claim described in paragraph (a) of this section, the amount of the credit or refund allowed or made may exceed the portion of the tax paid within the period prescribed in section 6511 (b) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to the allowance of a credit against income tax referred to in paragraph (a) of this section.

§ 301.6511(e) STATUTORY PROVISIONS; LIMITATIONS ON CREDIT OR REFUND; SPECIAL RULES IN CASE OF MANUFACTURED SUGAR.

SEC. 6511. LIMITATIONS ON CREDIT OR REFUND. * * *

(e) SPECIAL RULES IN CASE OF MANUFACTURED SUGAR.—

(1) USE AS LIVESTOCK FEED OR FOR DISTILLATION OF ALCOHOL.—No payment shall be allowed under section 6418(a) unless within 2 years after the right to such payment has accrued a claim therefor is filed by the person entitled thereto.

(2) EXPORTATION.—No payment shall be allowed under section 6418(b) unless within 2 years after the right to such payment has accrued a claim therefor is filed by the person entitled thereto.

§301.6511(e)-1 SPECIAL RULES APPLICABLE TO MANUFACTURED SUGAR.—(a) *Use as livestock feed and for distillation of alcohol.*—No payment shall be allowed or made under section 6418(a) unless within 2 years after the date the right to such payment has accrued a claim therefor is filed by the person entitled thereto. Such right accrues as of the date the manufactured sugar, or article manufactured therefrom, is used for a purpose for which payment is allowable under section 6418(a).

(b) *Exportation.*—No payment shall be allowed or made under section 6418(b) unless within 2 years after the date the right to such payment has accrued a claim therefor is filed by the person entitled thereto. Such right accrues as of the date the articles are exported.

§ 301.6511(f) STATUTORY PROVISIONS; LIMITATIONS ON CREDIT OR REFUND; CROSS REFERENCES.

SEC. 6511. LIMITATIONS ON CREDIT OR REFUND. * * *

(f) CROSS REFERENCES.—

(1) For time return deemed filed and tax considered paid, see section 6513.

(2) For limitations with respect to certain credits against estate tax, see sections 2011(c), 2014(b), and 2015.

(3) For limitations in case of floor stocks refunds, see section 6412.

(4) For a period of limitations for credit or refund in the case of joint income returns after separate returns have been filed, see section 6013(b)(3).

§ 301.6512 STATUTORY PROVISIONS; LIMITATIONS IN CASE OF PETITION TO TAX COURT.

SEC. 6512. LIMITATIONS IN CASE OF PETITION TO TAX COURT.

(a) EFFECT OF PETITION TO TAX COURT.—If the Secretary or his delegate has mailed to the taxpayer a notice of deficiency under section

6212(a) (relating to deficiencies of income, estate, and gift taxes) and if the taxpayer files a petition with the Tax Court within the time prescribed in section 6213(a), no credit or refund of income tax for the same taxable year, of gift tax for the same calendar year, or of estate tax in respect of the taxable estate of the same decedent, in respect of which the Secretary or his delegate has determined the deficiency shall be allowed or made and no suit by the taxpayer for the recovery of any part of the tax shall be instituted in any court except—

(1) As to overpayments determined by a decision of the Tax Court which has become final; and

(2) As to any amount collected in excess of an amount computed in accordance with the decision of the Tax Court which has become final; and

(3) As to any amount collected after the period of limitation upon the making of levy or beginning a proceeding in court for collection has expired; but in any such claim for credit or refund or in any such suit for refund the decision of the Tax Court which has become final, as to whether such period has expired before the notice of deficiency was mailed, shall be conclusive.

(b) OVERPAYMENT DETERMINED BY TAX COURT.—

(1) JURISDICTION TO DETERMINE.—If the Tax Court finds that there is no deficiency and further finds that the taxpayer has made an overpayment of income tax for the same taxable year, of gift tax for the same calendar year, or of estate tax in respect of the taxable estate of the same decedent, in respect of which the Secretary or his delegate determined the deficiency, or finds that there is a deficiency but that the taxpayer has made an overpayment of such tax, the Tax Court shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the Tax Court has become final, be credited or refunded to the taxpayer.

(2) LIMIT ON AMOUNT OF CREDIT OR REFUND.—No such credit or refund shall be allowed or made of any portion of the tax unless the Tax Court determines as part of its decision that such portion was paid—

(A) after the mailing of the notice of deficiency, or

(B) within the period which would be applicable under section 6511(b)(2), (c), or (d), if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment.

§ 301.6512–1 LIMITATIONS IN CASE OF PETITION TO TAX COURT.—(a) *Effect of petition to Tax Court.*—(1) *General rule.*—If a person, having a right to file a petition with the Tax Court with respect to a deficiency in income, estate, or gift tax imposed by subtitle A or B, has filed such petition within the time prescribed in section 6213(a), no credit or refund of income tax for the same taxable year, or of gift tax for the same calendar year, or of estate tax in respect of the taxable estate of the same decedent, in respect of which a district director (or an Assistant Regional Commissioner, Appellate) has determined the deficiency, shall be allowed or made, and no suit in any court for the recovery of any part of such tax shall be instituted by the taxpayer, except as to items set forth in subparagraph (2) of this paragraph.

(2) *Exceptions.*—The exceptions to the rule stated in subparagraph (1) of the paragraph are as follows:

(i) An overpayment determined by a decision of the Tax Court which has become final;

(ii) Any amount collected in excess of an amount computed in accordance with the decision of the Tax Court which has become final; and

(iii) Any amount collected after the expiration of the period of limitation upon levying or beginning a proceeding in court for collection,

(b) *Overpayment determined by Tax Court.*—If the Tax Court finds that there is no deficiency and further finds that the taxpayer has made an overpayment of income tax for the same taxable year, or the gift tax for the same calendar year, or of estate tax in respect of the taxable estate of the same decedent, in respect of which a District Director (or an Assistant Regional Commissioner, Appellate) has determined the deficiency, or finds that there is a deficiency but that the taxpayer has made an overpayment of such tax, the overpayment determined by the Tax Court shall be credited or refunded to the taxpayer when the decision of the Tax Court has become final. (See section 7481, relating to the date when Tax Court decision becomes final.) No such credit or refund shall be allowed or made of any portion of the tax unless the Tax Court determines as part of its decision that such portion was paid—

(1) After the mailing of the notice of deficiency, or

(2) Within the period which would be applicable under section 6511(b)(2), (c), or (d) (see §§ 301.6511(b)-1, 301.6511(c)-1, 301.6511(d)-1, 301.6511(d)-2, and 301.6511(d)-3, if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment.

(c) *Jeopardy assessments.* In the case of a jeopardy assessment made under section 6861(a), if the amount which should have been assessed as determined by a decision of the Tax Court which has become final is less than the amount already collected, the excess payment shall be credited or refunded subject to a determination being made by the Tax Court with respect to the time of payment as stated in paragraph (b) of this section.

(d) *Disallowance of deficiency by reviewing court.*—If the amount of the deficiency determined by the Tax Court (in a case where collection has not been stayed by the filing of a bond) is disallowed in whole or in part by the reviewing court, then the overpayment resulting from such disallowance shall be credited or refunded without the making of claim therefor, subject to a determination being made by the Tax Court with respect to the time of payment as stated in paragraph (b) of this section. (See section 7481, relating to date Tax Court decision becomes final.)

(e) *Collection in excess of amount determined by Tax Court.*—Where the amount collected is in excess of the amount computed in accordance with the decision of the Tax Court which has become final. the excess payment shall be credited or refunded within the period of limitation provided in section 6511.

(f) *Collection after expiration of statutory period.*—Where an amount is collected after the statutory period of limitation upon the beginning of levy or a proceeding in court for collection has expired (see section 6502, relating to collection after assessment), the taxpayer may file a claim for refund of the amount so collected within the period of limitation provided in section 6511. In any such case,

the decision of the Tax Court as to whether the statutory period upon collection of the tax expired before notice of the deficiency was mailed shall, when the decision becomes final, be conclusive.

§ 301.6513 STATUTORY PROVISIONS; TIME RETURN DEEMED FILED AND TAX CONSIDERED PAID.

SEC. 6513. TIME RETURN DEEMED FILED AND TAX CONSIDERED PAID.

(a) EARLY RETURN OR ADVANCE PAYMENT OF TAX.—For purposes of section 6511, any return filed before the last day prescribed for the filing thereof shall be considered as filed on such last day. For purposes of section 6511(b)(2) and (c) and section 6512, payment of any portion of the tax made before the last day prescribed for the payment of the tax shall be considered made on such last day. For purposes of this subsection, the last day prescribed for filing the return or paying the tax shall be determined without regard to any extension of time granted the taxpayer and without regard to any election to pay the tax in installments.

(b) PREPAID INCOME TAX.—For purposes of section 6511 or 6512, any tax actually deducted and withheld at the source during any calendar year under chapter 24 shall, in respect of the recipient of the income, be deemed to have been paid by him on the 15th day of the fourth month following the close of his taxable year with respect to which such tax is allowable as a credit under section 31. For purposes of section 6511 of 6512, any amount paid as estimated income tax for any taxable year shall be deemed to have been paid on the last day prescribed for filing the return under section 6012 for such taxable year (determined without regard to any extension of time for filing such return).

(c) RETURN AND PAYMENT OF SOCIAL SECURITY TAXES AND INCOME TAX WITHOLDING.—Notwithstanding subsection (a), for purposes of section 6511 with respect to any tax imposed by chapter 21 or 24—

(1) If a return for any period ending with or within a calendar year is filed before April 15 of the succeeding calendar year, such return shall be considered filed on April 15 of such succeeding calendar year; and

(2) If a tax with respect to remuneration paid during any period ending with or within a calendar year is paid before April 15 of the succeeding calendar year, such tax shall be considered paid on April 15 of such succeeding calendar year.

(d) OVERPAYMENT OF INCOME TAX CREDITED TO ESTIMATED TAX.—If any overpayment of income tax is, in accordance with section 6402(b), claimed as a credit against estimated tax for the succeeding taxable year, such amount shall be considered as a payment of the income tax for the succeeding taxable year (whether or not claimed as a credit in the return of estimated tax for such succeeding taxable year), and no claim for credit or refund of such overpayment shall be allowed for the taxable year in which the overpayment arises.

§ 301.6513–1 TIME RETURN DEEMED FILED AND TAX CONSIDERED PAID.—(a) *Early return or advance payment of tax.*—For purposes of section 6511, a return (other than the employment tax returns referred to in paragraph (c) of this section) filed before the last day prescribed by law or regulations for the filing thereof shall be considered as filed on such last day. For purposes of section 6511(b)(2) and (c) and section 6512, payment of any portion of the tax made before the last day prescribed for payment shall be considered made on such last day. An extension of time for filing a return or for paying any tax, or an election to pay any tax in installments, shall not be given any effect in determining under this section the last day prescribed for filing a return or paying any tax.

(b) *Prepaid income tax.*—For purposes of section 6511 (relating to limitations on credit or refund) or section 6512 (relating to limita-

tions in case of petition to Tax Court), any tax actually deducted and withheld at the source during any calendar year under chapter 24 (relating to collection of income tax at source on wages) shall, in respect of the recipient of the income, be deemed to have been paid by him on the 15th day of the fourth month following the close of his taxable year with respect to which such tax is allowable as a credit under section 31 (relating to tax withheld on wages). For purposes of section 6511 or 6512, any amount paid as estimated income tax for any taxable year shall be deemed to have been paid on the last day prescribed for filing the return under section 6012 (relating to persons required to make returns of income) for such taxable year (determined without regard to any extension of time for filing such return).

(c) *Return and payment of social security taxes and income tax withholding.*—If a return of tax under chapter 21 (relating to the Federal Insurance Contributions Act) or chapter 24 (relating to the collection of income tax at source on wages) for any period ending with or within a calendar year is filed before April 15 of the succeeding calendar year or if a tax with respect to remuneration paid during any period ending with or within a calendar year is paid before such date, for purposes of section 6511 (relating to limitations on credit or refund) the return shall be considered filed, or the tax considered paid, on April 15th of such succeeding calendar year.

(d) *Overpayment of income tax credited to estimated tax.*—If a taxpayer elects under the provisions of section 6402(b) to credit an overpayment of income tax for a taxable year against estimated tax for the succeeding taxable year, the amount so credited shall be considered a payment of income tax for such succeeding taxable year (whether or not claimed as a credit on the estimated tax return for such succeeding taxable year). If the treatment of such amount as a payment of income tax for the succeeding taxable year results in an overpayment for such succeeding taxable year, the period of limitations applicable to such overpayment is determined by reference to that taxable year. An election so to credit an overpayment of income tax precludes the allowance of a claim for credit or refund of such overpayment for the taxable year in which the overpayment arises.

§ 301.6514(a) STATUTORY PROVISIONS; CREDITS OR REFUNDS AFTER PERIOD OF LIMITATION.

SEC. 6514. CREDITS OR REFUNDS AFTER PERIOD OF LIMITATION.

(a) CREDITS OR REFUNDS AFTER PERIOD OF LIMITATION.—A refund of any portion of an internal revenue tax shall be considered erroneous and a credit of any such portion shall be considered void—

(1) EXPIRATION OF PERIOD FOR FILING CLAIM.—If made after the expiration of the period of limitation for filing claim therefor, unless within such period claim was filed; or

(2) DISALLOWANCE OF CLAIM AND EXPIRATION OF PERIOD FOR FILING SUIT.—In the case of a claim filed within the proper time and disallowed by the Secretary or his delegate, if the credit or refund was made after the expiration of the period of limitation for filing suit, unless within such period suit was begun by the taxpayer.

(3) RECOVERY OF ERRONEOUS REFUNDS.—

For procedure by the United States to recover erroneous refunds, see sections 6532(b) and 7405.

§ 301.6514(a)–1 CREDITS OR REFUNDS AFTER PERIOD OF LIMITATION.—(a) A refund of any portion of any internal revenue tax (or any interest, additional amount, addition to the tax, or assessable penalty) shall be considered erroneous and a credit of any such portion shall be considered void—

(1) If made after the expiration of the period of limitation prescribed by section 6511 for filing claim therefor, unless prior to the expiration of such period claim was filed, or

(2) In the case of a timely claim, if the credit or refund was made after the expiration of the period of limitation prescribed by section 6532(a) for the filing of suit, unless prior to the expiration of such period suit was begun.

(b) For procedure by the United States to recover erroneous refunds, see sections 6532(b) and 7405.

§ 301.6514(b) STATUTORY PROVISIONS; CREDIT AFTER PERIOD OF LIMITATION.

SEC. 6514. CREDITS OR REFUNDS AFTER PERIOD OF LIMITATION. * * *

(b) CREDIT AFTER PERIOD OF LIMITATION.—Any credit against a liability in respect of any taxable year shall be void if any payment in respect of such liability would be considered an overpayment under section 6401(a).

§ 301.6514(b)–1 CREDIT AGAINST BARRED LIABILITY.—Any credit against a liability in respect of any taxable year shall be void if the collection of such liability would be barred by the applicable statute of limitations at the time such credit is made.

§ 301.6515 STATUTORY PROVISIONS; CROSS REFERENCES.

SEC. 6515. CROSS REFERENCES.

For limitations in case of—
(1) Adjustments incident to involuntary liquidation of inventory, see section 1321.
(2) War loss recoveries where prior benefit rule is elected, see section 1335.
(3) Deficiency dividends of a personal holding company, see section 547.
(4) Overpayment in certain renegotiations of war contracts, see section 1481.
(5) Tentative carry-back adjustments, see section 6411.
(6) Service in a combat zone, etc., see section 7508.
(7) Suits for refund by taxpayers, see section 6532(a).

Mitigation of Effect of Period of Limitations

§ 301.6521 STATUTORY PROVISIONS; MITIGATION OF EFFECT OF LIMITATION IN CASE OF RELATED TAXES UNDER DIFFERENT CHAPTERS.

SEC. 6521. MITIGATION OF EFFECT OF LIMITATION IN CASE OF RELATED TAXES UNDER DIFFERENT CHAPTERS.

(a) SELF-EMPLOYMENT TAX AND TAX ON WAGES.—In the case of the tax imposed by chapter 2 (relating on tax on self-employment income) and the tax imposed by section 3101 (relating to tax on employees under the Federal Insurance Contributions Act)—

(1) If an amount is erroneously treated as self-employment income, or if an amount is erroneously treated as wages, and

(2) If the correction of the error would require an assessment of one such tax and the refund or credit of the other tax, and

(3) If at any time the correction of the error is authorized as to one such tax but is prevented as to the other tax by any law or rule of law (other than section 7122, relating to compromises),

then, if the correction authorized is made, the amount of the assessment, or the amount of the credit or refund, as the case may be, authorized

as to the one tax shall be reduced by the amount of the credit or refund, or the amount of the assessment, as the case may be, which would be required with respect to such other tax for the correction of the error if such credit or refund, or such assessment, of such other tax were not prevented by any law or rule of law (other than section 7122, relating to compromises).

(b) DEFINITIONS.—For purposes of subsection (a), the terms "self-employment income" and "wages" shall have the same meaning as when used in section 1402(b).

§ 301.6521–1 MITIGATION OF EFFECT OF LIMITATION IN CASE OF RELATED EMPLOYEE SOCIAL SECURITY TAX AND SELF-EMPLOYMENT TAX.—(a) Section 6521 may be applied in the correction of a certain type of error involving both the tax on self-employment income under section 1401 and the employee tax under section 3101 if the correction of the error as to one tax is, on the date the correction is authorized, prevented in whole or in part by the operation of any law or rule of law other than section 7122, relating to compromises. Examples of such law are sections 6212(c), 6401(a), 6501, 6511, 6512(a), 6514, 6532, 6901(c), (d) and (e), 7121, and 7459(e).

(b) If the liability for either tax with respect to which the error was made has been compromised under section 7122, the provisions of section 6521 limiting the correction with respect to the other tax do not apply.

(c) Section 6521 is not applicable if, on the date of the authorization, correction of the effect of the error is permissible as to both taxes without recourse to such section.

(d) If, because an amount of wages, as defined in section 3121(a), is erroneously treated as self-employment income, as defined in section 1402(b), or an amount of self-employment income is erroneously treated as wages, it is necessary in correcting the error to assess the correct tax and give a credit or refund for the amount of the tax erroneously paid, and if either, but not both, of such adjustments is prevented by any law or rule of law (other than section 7122), the amount of the assessment, or the amount of the credit or refund, authorized shall reflect the adjustment which would be made in respect of the other tax (either the tax on self-employment income under section 1401 or the employee tax under section 3101) but for the operation of such law or rule of law. For example, assume that during 1955 A paid $10 as tax on an amount erroneously treated as "wages", when such amount was actually self-employment income, and that credit or refund of the $10 is not barred. A should have paid a self-employment tax of $15 on the amount. If the assessment of the correct tax, that is, $15, is barred by the statute of limitations, no credit or refund of the $10 shall be made without offsetting against such $10 the $15, assessment of which is barred. Thus, no credit or refund in respect of the $10 can be made.

(e) As another example, assume that during 1955 a taxpayer reports wages of $4,200 and net earnings from self-employment of $900. By reason of the limitations of section 1402(b) he shows no self-employment income. Assume further that by reason of a final decision by the Tax Court of the United States, further adjustments to the taxpayer's income tax liability are barred. The question of the amount of his wages, as defined in section 3121, was not in issue in the Tax

Court litigation, but it is subsequently determined (within the period of limitations applicable under the Federal Insurance Contributions Act) that $700 of the $4,200 reported as wages was not for employment as defined in section 3121(b). Therefore, the taxpayer is entitled to the allowance of a refund of the $14 tax paid on such remuneration under section 3101. The reduction of his wages from $4,200 to $3,500 would result in the determination of $700 self-employment income, the tax on which is $21 for the year. Under section 6521, the overpayment of $14 would be offset by the barred deficiency of $21, thus eliminating the refund otherwise allowable. If the facts were changed so that the taxpayer erroneously paid tax on self-employment income of $700, having been taxed on only $3,500 as wages, and within the period of limitations applicable under the Federal Insurance Contributions Act, it is determined that his wages were $4,200, the tax of $14 under section 3101, otherwise collectible, would be eliminated by offsetting under section 6521 the barred overpayment of $21. The balance of the barred overpayment, $7, cannot be credited or refunded.

(f) Another illustration of the operation of section 6521 is the case of a taxpayer who, for 1955, is erroneously taxed on $2,500 as wages, the tax on which is $50, and who reports no self-employment income. After the period of limitations has run on the refund of the tax under the Federal Insurance Contributions Act, it is determined that the amount treated as wages should have been reported as net earnings from self-employment. The taxpayer's self-employment income would then be $2,500 and the tax thereon would be $75. Assume that the period of limitations applicable to subtitle A has not expired, and that a notice of deficiency may properly be issued. Under section 6521, the amount of the deficiency of $75 must be reduced by the barred overpayment of $50.

§ 301.6521-2 Law Applicable in Determination of Error.—The question of whether there was an erroneous treatment of self-employment income or of wages is determined under the provisions of law and regulations applicable with respect to the year or other taxable period as to which the error was made. The fact that the error was in pursuance of an interpretation, either judicial or administrative, accorded such provisions of law and regulations at the time the action involved was taken is not necessarily determinative of this question. For example, if a later judicial decision authoritatively alters such interpretation so that such action is contrary to the applicable provisions of the law and regulations as later interpreted, the error comes within the scope of section 6521.

Periods of Limitation in Judicial Proceedings

§ 301.6531 Statutory Provisions; Periods of Limitation on Criminal Prosecutions.

SEC. 6531. PERIODS OF LIMITATION ON CRIMINAL PROSECUTIONS.

No person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal revenue laws unless the indictment is found or the information instituted within 3 years next after the commission of the offense, except that the period of limitation shall be 6 years—

(1) for offenses involving the defrauding or attempting to defraud the United States or any agency thereof, whether by conspiracy or not, and in any manner;

(2) for the offense of willfully attempting in any manner to evade or defeat any tax or the payment thereof;

(3) for the offense of willfully aiding or assisting in, or procuring, counseling, or advising, the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a false or fraudulent return, affidavit, claim, or document (whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document);

(4) for the offense of willfully failing to pay any tax, or make any return (other than a return required under authority of part III of subchapter A of chapter 61) at the time or times required by law or regulations;

(5) for offenses described in sections 7206 (1) and 7207 (relating to false statements and fraudulent documents);

(6) for the offense described in section 7212(a) (relating to intimidation of officers and employees of the United States);

(7) for offenses described in section 7214(a) committed by officers and employees of the United States; and

(8) for offenses arising under section 371 of Title 18 of the United States Code, where the object of the conspiracy is to attempt in any manner to evade or defeat any tax or the payment thereof.

The time during which the person committing any of the various offenses arising under the internal revenue laws is outside the United States or is a fugitive from justice within the meaning of section 3290 of Title 18 of the United States Code, shall not be taken as any part of the time limited by law for the commencement of such proceedings. (The preceding sentence shall also be deemed an amendment to section 3748(a) of the Internal Revenue Code of 1939, and shall apply in lieu of the sentence in section 3748(a) which relates to the time during which a person committing an offense is absent from the district wherein the same is committed, except that such amendment shall apply only if the period of limitations under section 3748 would, without the application of such amendment, expire more than 3 years after the date of enactment of this title, and except that such period shall not, with the application of this amendment, expire prior to the date which is 3 years after the date of enactment of this title.) Where a complaint is instituted before a commissioner of the United States within the period above limited, the time shall be extended until the date which is 9 months after the date of the making of the complaint before the commissioner of the United States. For the purpose of determining the periods of limitation on criminal prosecutions, the rules of section 6513 shall be applicable.

§ 301.6532 Statutory Provisions; Periods of Limitation on Suits.

SEC. 6532. PERIODS OF LIMITATION ON SUITS.

(a) Suits by Taxpayers for Refund.—

(1) General rule.—No suit or proceeding under section 7422(a) for the recovery of any internal revenue tax, penalty, or other sum, shall be begun before the expiration of 6 months from the date of filing the claim required under such section unless the Secretary or his delegate renders a decision thereon within that time, nor after the expiration of 2 years from the date of mailing by registered mail by the Secretary or his delegate to the taxpayer of a notice of the disallowance of the part of the claim to which the suit or proceeding relates.

(2) Extension of time.—The 2-year period prescribed in paragraph (1) shall be extended for such period as may be agreed upon in writing between the taxpayer and the Secretary or his delegate.

(3) Waiver of notice of disallowance.—If any person files

a written waiver of the requirement that he be mailed a notice of disallowance, the 2-year period prescribed in paragraph (1) shall begin on the date such waiver is filed.

(4) RECONSIDERATION AFTER MAILING OF NOTICE.—Any consideration, reconsideration, or action by the Secretary or his delegate with respect to such claim following the mailing of a notice by registered mail of disallowance shall not operate to extend the period within which suit may be begun.

(b) SUITS BY UNITED STATES FOR RECOVERY OF ERRONEOUS REFUNDS.—Recovery of an erroneous refund by suit under section 7405 shall be allowed only if such suit is begun within 2 years after the making of such refund, except that such suit may be brought at any time within 5 years from the making of the refund if it appears that any part of the refund was induced by fraud or misrepresentation of a material fact.

§ 301.6532–1 PERIODS OF LIMITATION ON SUITS BY TAXPAYERS.—(a) No suit or proceeding under section 7422 (a) for the recovery of any internal revenue tax, penalty, or other sum shall be begun until whichever of the following first occurs:

(1) The expiration of 6 months from the date of the filing of the claim for credit or refund, or

(2) A decision is rendered on such claim prior to the expiration of 6 months after the filing thereof.

Except as provided in paragraph (b) of this section, no suit or proceeding for the recovery of any internal revenue tax, penalty, or other sum may be brought after the expiration of 2 years from the date of mailing by registered mail by a district director or an assistant regional commissioner to a taxpayer of a notice of disallowance of the part of the claim to which the suit or proceeding relates.

(b) The 2-year period described in paragraph (a) of this section may be extended if an agreement to extend the running of the period of limitations is executed. The agreement must be signed by the taxpayer or by an attorney, agent, trustee, or other fiduciary on behalf of the taxpayer. If the agreement is signed by a person other than the taxpayer, it shall be accompanied by an authenticated copy of the power of attorney or other legal evidence of the authority of such person to act on behalf of the taxpayer. If the taxpayer is a corporation, the agreement should be signed with the corporate name followed by the signature of a duly authorized officer of the corporation. The agreement will not be effective until signed by a district director or an assistant regional commissioner.

(c) The taxpayer may sign a waiver of the requirement that he be mailed a notice of disallowance. Such waiver is irrevocable and will commence the running of the 2-year period described in paragraph (a) of this section on the date the waiver is filed. The waiver shall set forth:

(1) The type of tax and the taxable period covered by the taxpayer's claim for refund;

(2) The amount of the claim;

(3) The amount of the claim disallowed;

(4) A statement that the taxpayer agrees the filing of the waiver will commence the running of the 2-year period provided for in section 6532(a)(1) as if a notice of disallowance had been sent the taxpayer by registered mail.

The filing of such a waiver prior to the expiration of 6 months from the date the claim was filed does not permit the filing of a suit for refund prior to the time specified in section 6532(a)(1) and paragraph (a) of this section.

(d) Any consideration, reconsideration, or other action with respect to a claim after the mailing by registered mail of a notice of disallowance or after the execution of a waiver referred to in paragraph (c) of this section, shall not extend the period for bringing suit or other proceeding under section 7422(a).

§ 301.6532–2 PERIODS OF LIMITATION ON SUITS BY THE UNITED STATES.—The United States may not recover any erroneous refund by civil action under section 7405 unless such action is begun within 2 years after the making of such refund. However, if any part of the refund was induced by fraud or misrepresentation of a material fact, the action to recover the erroneous refund may be brought at any time within 5 years from the date the refund was made.

§ 301.6533 STATUTORY PROVISIONS; CROSS REFERENCES.

SEC. 6533. CROSS REFERENCES.

(1) For period of limitation in respect of civil actions for fines, penalties, and forfeitures, see section 2462 of Title 28 of the United States Code.
(2) For extensions of time by reason of armed service in a combat zone, see section 7508.
(3) For suspension of running of statute until 3 years after termination of hostilities, see section 3287 of Title 18.

GENERAL RULES

Effective Date and Related Provisions

§ 301.7851 STATUTORY PROVISIONS; APPLICABILITY OF REVENUE LAWS.

SEC. 7851. APPLICABILITY OF REVENUE LAWS.

(a) GENERAL RULES.—Except as otherwise provided in any section of this title—

* * * * * * *

(6) SUBTITLE F.

(A) *General Rule.*—The provisions of subtitle F [inc. chapter 66, relating to limitations] shall take effect on the day after the date of enactment of this title and shall be applicable with respect to any tax imposed by this title. * * *

* * * * * * *

[NOTE.—Chapter 66 of the Internal Revenue Code of 1954, relating to limitations, is applicable only with respect to the taxes imposed by the 1954 Code. The provisions of the Internal Revenue Code of 1939 relating to limitations are applicable with respect to the taxes imposed by the 1939 Code.]

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved April 30, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Filed by the Division of the Federal Register May 2, 1956, 8:54 a. m.)

CHAPTER 68.—ADDITIONS TO THE TAX, ADDITIONAL AMOUNTS, AND ASSESSABLE PENALTIES

SUBCHAPTER A.—ADDITIONS TO THE TAX AND ADDITIONAL AMOUNTS

SECTION 6651.—FAILURE TO FILE TAX RETURN

(Also Part II, Section 3612(d); Regulations 128, Section 408.909.) Rev. Rul. 56–158

An insolvent debtor, subject to the Federal Insurance Contributions Act taxes and to income tax withholding, made a general assignment of his assets for the benefit of creditors on March 1, 1955. The Employer's Quarterly Federal Tax Return, Form 941, was not filed until May 31, 1955, which date was subsequent to the due date of the return. In the absence of a showing of reasonable cause for the delinquency, the District Director of Internal Revenue asserted the delinquency penalty provided by section 6651(a) of the Internal Revenue Code of 1954. The assignee protested such action. *Held*, there is no prohibition against the assessment of the delinquency penalty provided by section 6651(a), *supra*, where the delinquency in the filing of the return occurs after the institution of an assignment proceeding. The assignee in the instant case is not relieved by statute or regulation from the duty of filing a timely return. Accordingly, since there is no showing of reasonable cause, the delinquency penalty was properly assessed. See also Rev. Rul. 54–427, C. B. 1954–2, 42.

CHAPTER 69.—GENERAL PROVISIONS RELATING TO STAMPS

SECTION 6805.—REDEMPTION OF STAMPS

Rev. Rul. 56–115

The documentary stamp tax on a foreign insurance policy is computed on the basis of the total premium charged, and is due when the insurance becomes effective. See section 4371 of the Internal Revenue Code of 1954 and part (1) of S. T. 743, C. B. XIII–1, 442 (1934), part (2) of which was revoked by M. T. 12, C. B. 1943, 1169. When a premium is unconditionally paid at the time the policy is issued, no refund of tax may be made even though a partial refund of the premium is allowed by the foreign underwriters. If, however, under the specific terms of the policy, the assured is not liable for any premiums covering conditional risks, unless and until the risks have been incurred, and the policy expires or is cancelled without such risks being incurred, any stamps affixed with respect to the conditional premiums would be redeemable. In any case in which the assured is entitled to a refund of all or a portion of the amount paid for documentary stamps, a claim for redemption, supported with copies of all pertinent documents or extracts therefrom, should be filed with the District Director of Internal Revenue. See Rev. Rul. 55–396, C. B. 1955–1, 522.

CHAPTER 77.—MISCELLANEOUS PROVISIONS

SECTION 7508.—TIME FOR PERFORMING CERTAIN ACTS POSTPONED BY REASON OF WAR

(Also Part II, Section 3804(f).) Rev. Rul. 56-298

With respect to the deferment of time for filing income tax returns and paying the tax under sections 7805(a) of the Internal Revenue Code of 1954 and 3804(f) of the Internal Revenue Code of 1939, the period of time which may be disregarded for taxpayers serving in the Armed Forces of the United States in Korea including those serving in support of such Armed Forces is 180 days after January 31, 1955, the date combatant activities in the Korean combat zone ceased.

The Internal Revenue Service has been requested to state its position as to the effect of Executive Order 10585, C. B. 1955-1, 17, on the period of time which may be disregarded for filing income tax returns and paying tax under section 7508(a) of 1954 Code (section 3804(f) of 1939 Code) with respect to those individuals serving in the Armed Forces of the United States or serving in support of such Armed Forces within the Korean combat zone.

Section 3804(f) of the Internal Revenue Code of 1939 and section 7508 of the Internal Revenue Code of 1954 provide, in part, for the postponement of the due date for the filing of income tax returns and payment of income tax in the case of individuals serving in the Armed Forces of the United States, or serving in support of such Armed Forces, in a combat zone during a period of combatant activities, or hospitalized outside the States of the Union and the District of Columbia as a result of injuries received while in a combat zone. The period of time to be disregarded in determining whether these acts are timely performed under either section includes the period of service in the combat zone, plus the period of continuous hospitalization outside the States of the Union and the District of Columbia attributable to injury received in such an area, and the next 180 days thereafter.

Executive Order 10585, *supra*, designated midnight of January 31, 1955, as the date of termination of combatant activities in areas comprising the combat zone in Korea and the waters adjacent thereto. Accordingly, for the purpose of providing additional time in the determination of a postponed income tax due date, the combat zone, as such, ceased to exist after midnight January 31, 1955, the date combatant activities in Korea ceased. As a result, the postponed due date for the filing of income tax returns and the payment of income tax for those taxpayers within the combat zone on January 31, 1955, who are also within the scope of section 3803(f) of the 1939 Code or section 7508(a) of the 1954 Code, was July 30, 1955, the 180th day after January 31, 1955.

This ruling should not be interpreted as limiting the due date for filing returns or paying income tax of individuals hospitalized outside the States of the Union and the District of Columbia as the result of injuries received in the combat zone of Korea prior to February 1, 1955.

CHAPTER 79.—DEFINITIONS

SECTION 7701.—DEFINITIONS

(Also Section 401.) Rev. Rul. 56-23
(Also Part II, Sections 165, 3797; Regulations 118, Sections 39.165–1, 39.3797–1.)

A group of doctors who adopt the form of an association in order to obtain the benefits of corporate status for purposes of section 401 (a) of the Internal Revenue Code of 1954 is in substance a partnership and the doctor-members are employers and therefore not employees. Furthermore, any period of service as members of a prior partnership will not be credited as a period of employment for purposes of the above section.

The contrary position expressed in the case of *United States* v. *Arthur R. Kintner et ux.*, 216 Fed. (2d) 418, will not be accepted by the Internal Revenue Service as a precedent in the disposition of other cases involving similar fact situations.

Advice has been requested whether an association of doctors which formerly operated as a partnership may be treated as a corporation for Federal income tax purposes and further whether a doctor-member of the former partnership was an employee of the partnership for the purpose of the requirements for establishing a pension plan under section 401(a) of the Internal Revenue Code of 1954, corresponding to section 165(a) of the 1939 Code.

These questions are posed because of the decision in *United States* v. *Arthur R. Kintner et ux.*, 216 Fed. (2d) 418. In that case, on the authority of *Ora L. Pelton, Sr. et al., Trustees* v. *Commissioner*, 82 Fed. (2d) 437, the court held that the association had more of the criteria of a corporation than of a partnership under *T. A. Morrissey et al., Trustees*, v. *Commissioner*, 296 U. S. 344, Ct. D. 1064, C. B. XV–1, 264 (1936), and it distinguished *Mobile Bar Pilots Association* v. *Commissioner*, 97 Fed. (2d) 695, Ct. D. 1417, C. B. 1939–2, 244, relating to the performance of pilotage services by an association of pilots. Having determined that the clinic in the Kintner case is an association which is treated for tax purposes as a corporation, notwithstanding the State does not include the practice of medicine in the listing of purposes for which a corporation may be formed, the court further held that the pension plan established by the association satisfies the requirements of section 165(a) of the 1939 Code. In reaching this conclusion, the court credited the doctor-members with prior years of service as partners as constituting qualifying years of employment for purposes of the pension plan of the association.

It is held that a group of doctors who adopt the form of an association in order to obtain the benefits of corporate status for purposes of section 401(a) of the Internal Revenue Code of 1954 is in substance a partnership for all purposes of the Internal Revenue Code. It follows that the doctor-members are employers and therefore not employees. Rev. Rul. 33, Part 2(a)(1), C. B. 1953–1, 267, at 269. Furthermore, any period of service as members of a prior partnership will not be credited as a period of employment for purposes of the above section. The contrary position expressed in the case of *United States* v. *Arthur R. Kintner et ux.*, 216 Fed. (2d) 418, will not be accepted by the Internal Revenue Service as a precedent in the disposition of other cases involving similar fact situations.

CHAPTER 80.—GENERAL RULES

SUBCHAPTER A.—APPLICATION OF INTERNAL REVENUE LAWS

SECTION 7805.—RULES AND REGULATIONS

Procedure to aid dealers in tobacco materials in the transition from Regulations 8 to the new regulations, 26 CFR, Part 280, with regard to permits, trade name certificates, bonds, and records. See Rev. Proc. 56–4, page 1019.

PART II

RULINGS AND DECISIONS UNDER THE INTERNAL REVENUE CODE OF 1939 AND OTHER RELATED PUBLIC LAWS

SUBPART A.—RULINGS AND DECISIONS UNDER THE INTERNAL REVENUE CODE OF 1939

Rulings and decisions published in Part II, Subpart A, of the Internal Revenue Bulletin are based on the application of provisions of the Internal Revenue Code of 1939 and, unless otherwise noted therein, are published without consideration as to any application of the provisions of the Internal Revenue Code of 1954, or the Federal Firearms Act or other public laws.

SUBTITLE A.—TAXES SUBJECT TO THE JURISDICTION OF THE BOARD OF TAX APPEALS

CHAPTER 1.—INCOME TAX

SUBCHAPTER B.—GENERAL PROVISIONS

PART II.—COMPUTATION OF NET INCOME

SECTION 22(a).—GROSS INCOME: GENERAL DEFINITION

REGULATIONS 118, SECTION 39.22(a)-1: What included in gross income. (Also Section 101; Section 39.101(14)-1.) — Rev. Rul. 56-93

A reorganized railroad company which has issued all of its first mortgage bonds and the majority of its shares of common stock to the Reconstruction Finance Corporation in satisfaction of a debt, and has also issued and set aside shares of its common stock for subscription through warrants issued to private creditors, is not exempt from Federal income taxes.

Advice has been requested whether the income of a reorganized railroad company is exempt from Federal income taxes under the following circumstances.

X railroad company, which emerged from proceedings for reorganization under section 77 of the Bankruptcy Act, issued all of its first mortgage bonds and approximately 75 percent of its authorized shares of common stock to the Reconstruction Finance Corporation (hereinafter referred to as R. F. C.) because of a claim arising from loans made by the R. F. C. to the trustee in bankruptcy of the railroad company. The railroad also issued warrants to private creditors for the purchase of the balance of the shares of common stock, which were issued and set aside for that purpose. The railroad company holds its charter from the State of *M*, and its primary purpose is the operation of a railroad, consisting of the hauling for hire of freight and passengers.

The question whether the exemption from all Federal taxes extended to the R. F. C. by act of Congress also extends to a business corporation, whose outstanding stock or obligations are owned by the R. F. C., must be determined not only from the statute respecting the R. F. C. and from the provisions of section 101 of the Internal Revenue Code of 1939 regarding nontaxable organizations, but also from certain conditions with respect to the purpose and control of the corporation.

The R. F. C. was made expressly exempt from all taxes imposed by the Federal Government, and this exemption was extended to any other public corporation wholly financed and wholly managed by the R. F. C. and to banks whose stock or obligations were acquired by the R. F. C. prior to July 1, 1947. Section 10, Reconstruction Finance Corporation Act, 47 Stat. 9, as amended, 15 U. S. C. 607. Section 101(14) of the 1939 Code provides that, in order for a corporation to be exempt from Federal income taxes, it must be organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the proceeds from such property, less expenses, to an organization which itself is exempt from the tax imposed by Chapter 1 of the 1939 Code. It may not operate a business. Section 101(15) of the 1939 Code provides that in order for a corporation to be exempt from Federal income taxes, it must have been chartered by an Act of Congress, be an instrumentality of the United States, and be exempt from Federal income taxes under its chartering act.

The other conditions which should be considered in determining the taxibility of a corporation controlled by a Federal agency, such as the R. F. C., are the domination and control arising from complete ownership of the corporate stock by the agency, whether the subsidiary corporation's existence is being maintained for a limited time and for the specific purpose of liquidation, the purpose underlying the creation of the agency and the broad tax exemption accorded it by Congress, and whether the subsidiary corporation repesents an asset of the agency from which a partial recoupment of its investment can be effected.

In the instant case, the company was not organized by the R. F. C., neither was it organized for the purpose of holding title to property for the benefit of a tax-exempt stockholder as required by section 101(14) of the 1939 Code; nor was it chartered by an Act of Congress, as an instrumentality of the United States, as required by section 101(15) of the 1939 Code. There is no question of liquidation since, according to the plan of reorganization, warrants in the hands of certain classes of private creditors for the purchase of common stock indicate a continuation of the railroad company with a view to eventual private ownership of the stock. Furthermore, in view of the holders of the stock warrants, it cannot be said that the R. F. C. has complete legal and beneficial ownership of the corporation.

Accordingly, in view of the foregoing facts, it is held that a reorganized railroad company, which has issued all of its first mortgage bonds and the majority of its shares of common stock to the Reconstruction Finance Corporation in satisfaction of a debt, and has also issued and set aside shares of its common stock for subscription through warrants issued to private creditors, is not exempt from Federal income taxes.

Due to a printing error, the amendment to Revenue Ruling 55–136, I. R. B. 1955–11, 12, announced in Internal Revenue Bulletin 1955–38, 28, dated September 19, 1955, was not reflected in Revenue Ruling 55–136 when it was published in Cumulative Bulletin 1955–1. The following Revenue Ruling is published to rectify that error. Although it supersedes Revenue Ruling 55–136, C. B. 1955–1, 213, this Revenue Ruling makes no change in the ruling, substantive or otherwise, but merely repeats the language which should have been reflected in Revenue Ruling 55–136 when it was published in Cumulative Bulletin 1955–1.

(Also Section 117 (f).) Rev. Rul. 56–299

Section 117(f) of the Internal Revenue Code of 1939 applies only to amounts received by reason of redemption of bonds. It does not apply to the amount of interest (whether paid in the form of discount or not) which is received by reason of holding the bond. Such interest or interest-equivalent payments are taxable as ordinary income under section 22 (a) of the Code.

Revenue Ruling 119, C. B. 1953–2, 95, modified. Revenue Ruling 55–136, C. B. 1955–1, 213, superseded.

Advice has been requested whether the Internal Revenue Service will continue to follow the position taken in Revenue Ruling 119, C. B. 1953–2, 95, with respect to bonds issued at a discount prior to January 1, 1955.

Revenue Ruling 119, *supra*, holds that the discount at which a "Twelve Year Dollar Savings Bond" of the State of Israel is originally issued constitutes interest which is taxable as ordinary income under section 22(a) of the Internal Revenue Code of 1939 when realized upon redemption. It does not represent an amount received upon retirement of the bond within the meaning of section 117(f) of the Internal Revenue Code of 1939.

Section 117(f) of the Code provides in part as follows:

* * * For the purposes of this chapter [chapter 1], amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by a corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

Prior to the enactment of section 117(f), the gain realized by the holder of a bond, upon its retirement, constituted ordinary income whereas the gain realized from an actual sale or exchange of a bond to a third party immediately prior to retirement constituted capital gain. The legislative history in connection with the enactment of section 117(f) in the 1934 Revenue Act indicates clearly that Congress was directing its attention solely to treating the redemption of a bond the same as a sale or exchange of a bond and did not contemplate covering the treatment of initial discount which, under the law in effect prior to 1934, was treated as ordinary income. The committee reports imply that Congress was thinking of amounts received upon retirement altogether in terms of amounts which would have represented gain or loss under section 111 and section 112 of the Revenue Act of 1934.

In *Commissioner* v. *George Peck Caulkins*, 144 Fed. (2d) 482, affirming 1 T. C. 656, acquiescence C. B. 1944, 5, the court held that the excess of the amount received by the taxpayer, pursuant to a contract with Investors Syndicate, over the aggregate payments made by him for an Accumulative Installment Certificate constitutes capital gain,

and stated that the certificate in question was "'an evidence of indebtedness' similar to a bond or debenture and hence falls within the statutory group governed by section 117(f)."

It has been the policy of the Internal Revenue Service to restrict the application of the Caulkins case to cases involving the identical facts. This position has been reconsidered in the light of the position taken in Revenue Ruling 119, *supra*, i. e., that the amount received upon the redemption of a bond which represents original or initial discount constitutes interest which is taxable as ordinary income. There is no logical basis in fact or in law to distinguish the discount element in the Accumulative Installment Certificate involved in the Caulkins case from the original discount element involved ordinarily in the issuance of any bonds. Accordingly, the acquiescence published in C. B. 1944, 5, has been withdrawn and a nonacquiescence has been published. See C. B. 1955–1, 7.

Revenue Ruling 119, *supra*, is modified to the extent that it is inconsistent with the views expressed herein. Pursuant to the authority contained in section 3791(b) of the Internal Revenue Code of 1939, the provisions of this Revenue Ruling will be applied without retroactive effect to any amounts received upon redemption of Accumulative Installment Certificates purchased during the period beginning December 25, 1944, (the date the acquiescence in the Caulkins case was announced) and ending December 31, 1954.

Revenue Ruling 55–136, C. B. 1955–1, 213, superseded.

SECTION 22(b).—GROSS INCOME: EXCLUSIONS FROM GROSS INCOME

Rev. Rul. 56–58

The sum paid to a minister as part of his compensation "for house allowance" is exempt from Federal income tax within the meaning of section 22(b)(6) of the 1939 Code.
I. T. 1694, C. B. II–1, 79 (1923), revoked.

Advice has been requested whether the Internal Revenue Service will continue to litigate issues similar to those involved in *Gideon B. Williamson, et ux.* v. *Commissioner*, 224 Fed. (2d) 377, reversing 22 T. C. 566, *James R. MacColl* v. *United States*, 91 Fed. Supp. 721, and *Conning* v. *Busey*, 127 Fed. Supp. 958, all involving the question of whether a sum paid to a minister as part of his compensation "for house allowance" is exempt from Federal income tax within the meaning of section 22(b)(6) of the Internal Revenue Code of 1939. This problem does not arise under the Internal Revenue Code of 1954 since section 107(2) thereof excludes from gross income the rental allowance paid to ministers, to the extent used to rent or provide a home.

The court decisions in the above-cited cases to the effect that the house allowance paid to a minister is exempt from Federal income tax have been accepted by the Service.

Because this new policy is in conflict with I. T. 1694, C. B. II–1, 79 (1923), which holds that an allowance made to a clergyman to cover the cost of a parsonage is not exempt from taxation, that ruling is hereby revoked.

REGULATIONS 118, SECTION 39.22(b)-1: Exemptions; exclusions from gross income. Ct. D. 1796

INCOME TAX—INTERNAL REVENUE CODE OF 1939—DECISION OF SUPREME COURT

1. CAPITAL GAINS—EXEMPTIONS—INDIANS—PROCEEDS FROM SALE OF TIMBER FROM ALLOTTED, RESTRICTED LAND OF NONCOMPETENT QUINAIELT INDIANS EXEMPT FROM TAX.

By treaty with the Quinaielt Indian Tribe, tribal lands were transferred to the United States and an area was reserved for the exclusive use of members of the tribe. In 1907, pursuant to treaty and under the General Allotment Act of 1887, a trust patent was issued to taxpayers, full-blood, noncompetent Quinaielt Indians, for 93 acres of tribal land within the reservation. Fee title to this land is still held by the United States in trust for taxpayers. In 1943, the Bureau of Indian Affairs of the United States Department of Interior sold the standing timber on this allotted land. Held, the proceeds from the sale of timber from the allotted land were not subject to Federal income taxation because such taxation would be in violation of the provisions of the Quinaielt Treaty, the trust patent, and the General Allotment Act.

2. CASE DISTINGUISHED.

Superintendent of Five Civilized Tribes v. *Commissioner*, 295 U. S. 418, Ct. D. 974, C. B. XIV-1, 158 (1935), distinguished.

3. JUDGMENT AFFIRMED.

Judgment of the United States Court of Appeals for the Ninth Circuit, 220 F. 2d 349, affirmed.

SUPREME COURT OF THE UNITED STATES

Clark Squire, Collector of Internal Revenue for the District of Washington, petitioner, v. *Horton Capoeman and Emma Capoeman, his wife*

On writ of certiorari to the United States Court of Appeals for the Ninth Circuit

[April 23, 1956]

OPINION

Mr. Chief Justice Warren delivered the opinion of the Court.

The question presented is whether the proceeds of the sale by the United States Government of standing timber on allotted lands on the Quinaielt Indian Reservation may be made subject to capital gains tax, consistently with applicable treaty and statutory provisions and the Government's role as respondents' trustee and guardian.

When white men first came to the Olympic Peninsula, in what is now the State of Washington, they found the Quinaielt Tribe of Indians and their neighboring allied tribes occupying a tract of country lying between the Coast Range and the Pacific Ocean. This vast tract, with the exception of a small portion reserved for their exclusive use, was ceded by the Quinaielts and their neighbors to the United States in exchange for protection and tutelage by the treaty of July 1, 1855, and January 25, 1856, 12 Stat. 971. According to this treaty, the Quinaielts were to have exclusive use of their reservation "and no white man shall be permitted to reside thereon without permission of the tribe. . . ." Article II. Years later, Congress passed the General Allotment Act of 1887.[1] Thereunder, Indians were to be allotted lands on their reservations not to exceed 160 acres of grazing land or 80 acres of agricultural land,[2] and 25 years after allotment the allottees were to receive the lands discharged of the trust under which the United States had theretofore held them, and to obtain a patent "in fee discharged of said trust and free of all

[1] 24 Stat. 388, 25 U. S. C. § 331 *et seq.*
[2] 25 U. S. C. § 331.

charge or incumbrance whatsoever,"[3] though the President might extend the period.[4]

Respondents, husband and wife, were born on the reservation, and are described by the Government as fullblood, noncompetent Quinaielt Indians. They have lived on the reservation all their lives with the exception of the time served by respondent husband in the Armed Forces of the United States during World War II.

Pursuant to the treaty and under the General Allotment Act of 1887, respondent husband was allotted from the treaty-guaranteed reservation 93.25 acres and received a trust patent[5] therefor dated October 1, 1907.[6] During the tax year here in question, the fee title to this land was still held by the United States in trust for him, and was not subject to alienation or encumbrance by him, except with the consent of the United States Government, which consent had never been given. The land was forest land, covered by coniferous trees from one hundred years to several hundred years old. It was not adaptable to agricultural purposes, and was of little value after the timber was cut.

In the year 1943, the Bureau of Indian Affairs of the United States Department of the Interior entered into a contract of sale for the standing timber on respondent's allotted land for the total price of $15,080.80. The Government received the sum of $8,418.28 on behalf of the respondent in that year.[7]

Upon demand of petitioner, Collector of Internal Revenue for the District of Washington, respondents filed a joint income tax return on October 10, 1947, for the tax year 1943, reporting long-term capital gain from the sale of the timber in that year. Simultaneously, they paid the taxes shown due. Thereafter, they filed a timely claim for refund of the taxes paid and contended that the proceeds from the sale of timber from the allotted land were not subject to Federal income taxation because such taxation would be in violation of the provisions of the Quinaielt Treaty, the trust patent, and the General Allotment Act. The claim for refund was denied, and this action was instituted. The District Court found that the tax had been unlawfully collected and ordered the refund. 110 F. Supp. 924. The Court of Appeals, agreeing with the District Court but recognizing a conflict between this case and the decision of the Tenth Circuit in the case of *Jones* v. *Taunah*, 186 F. 2d 445, affirmed. 220 F. 2d 349. Because of the apparent conflict, we granted certiorari. 350 U. S. 816.

The Government urges us to view this case as an ordinary tax case without regard to the treaty, relevant statutes, congressional policy concerning Indians, or the guardian-ward relationship between the United States and these particular Indians. It argues:

> "As citizens of the United States they are taxable under the broad provisions of Sections 11 and 22(a) of the Internal Revenue Code of 1939, which imposes

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[3] *Id.*, § 348.

[4] *Ibid.* The trust period here involved has regularly been extended by Executive Order. See note following 25 U. S. C. § 348, and see 25 U. S. C. § 462, which provides: "The existing periods of trust placed upon any Indian lands and any restriction on alienation thereof are extended and continued until otherwise directed by Cogress."

[5] The term "patent" inadequately describes respondents' interest. "Congress . . . was careful to avoid investing the allottee with the title in the first instance, and directed that there should be issued to him what . . . is in reality an allotment certificate. . . ." *Monson* v. *Simonson*, 231 U. S. 341, 345.

[6] In pertinent part, the patent provides:

"Now know ye, That the United States of America, in consideration of the premises, has allotted, and by these presents does allot, unto the said Horton Capoeman, the land above described, and hereby declares that it does and will hold the land thus allotted (subject to all statutory provisions and restrictions) for the period of twenty-five years, in trust for the sole use and benefit of the said Indian, and that at the expiration of said period the United States will convey the same by patent to said Indian, in fee, discharged of said trust and free of all charge or incumbrance whatsoever, ..."

[7] This sale seems to have followed a pattern generally adopted by the Government in selling timber from Indian allotments. Huge areas of forest are put up for competitive bids by lumber companies. These tracts include the tribal forest lands and individual allotments, with the consent of tribal councils and individual allottees. The successful bidder is required to make an immediate advance payment of a large proportion of the estimated value of the lumber in the tract. Since as much as 640 million board feet have been sold at one time, this requirement makes it economically infeasible for any but the largest companies to submit bids. The uncertainties of such large scale operations, which are to be carried on over 25- or 30-year periods, coupled with local quality and accessibility variables, has resulted in substantially lower than prevailing market bids. In some instances, the return to other sellers of comparable timber was two or three times that received by the Indians. See Transcript of November 28, 1955, Joint Hearing of Subcommittee on Legislative Oversight Function of the Senate Committee on Interior and Insular Affairs and of Subcommittee on Public Works and Resources of the House Committee on Government Operations, 2151–2217, and *passim*.

a tax on the net income of every individual, derived from any source whatever. There is no exemption from tax in the Quinaielt Treaty, the General Allotment Act, the taxing statute, or in any other legislation dealing with taxpayers' affairs. . . .

"Even if it be assumed that the United States would be prohibited from imposing a direct tax on the allotted land held in trust for the taxpayers, there would, nevertheless, be no prohibition against a Federal tax on the income derived from the land, since a tax on such income is not the same as a tax on the source of the income, the land." [8]

We agree with the Government that Indians are citizens and that in ordinary affairs of life, not governed by treaties or remedial legislation, they are subject to the payment of income taxes as are other citizens. We also agree that to be valid, exemptions to tax laws should be clearly expressed. But we cannot agree that taxability of petitioners in these circumstances is unaffected by the treaty, the trust patent or the Allotment Act.

The courts below held that imposition of the tax here in question is inconsistent with the Government's promise to transfer the fee "free of all charge or incumbrance whatsoever." Although this statutory provision is not expressly couched in terms of nontaxability, this Court has said that

"Doubtful expressions are to be resolved in favor of the weak and defenseless people who are the wards of the nation, dependent upon its protection and good faith. Hence, in the words of Chief Justice Marshall, 'The language used in treaties with the Indians should never be construed to their prejudice. If words be made use of, which are susceptible of a more extended meaning than their plain import, as connected with the tenor of the treaty, they should be considered as used only in the latter sense.' *Worcester* v. *The State of Georiga*, 6 Pet. 515, 582." *Carpenter* v. *Shaw*, 280 U. S. 363, 367.

Thus, the general words "charge or incumbrance" might well be sufficient to include taxation. But Congress, in an amendment to the General Allotment Act, gave additional force to respondents' position. Section 6 of that Act was amended to include a proviso—

"That the Secretary of the Interior may, in his discretion, and he is authorized, whenever he shall be satisfied that any Indian allottee is competent and capable of managing his or her affairs at any time to cause to be issued to such allottee a patent in fee simple, and thereafter all restrictions as to sale, incumbrance, or taxation of said land shall be removed and said land shall not be liable to the satisfaction of any debt contracted prior to the issuing of such patent. . . ." [9]

The Government argues that this amendment was directed solely at permitting state and local taxation after a transfer in fee, but there is no indication in the legislative history of the amendment that it was to be so limited.[10] The fact that this amendment antedated the Federal income tax by 10 years also seems irrelevant. The literal language of the proviso evinces a congressional intent to subject an Indian allotment to all taxes only after a patent in fee is issued to the allottee. This, in turn, implies that, until such time as the patent is issued, the allotment shall be free from all taxes, both those in being and those which might in the future be enacted.[11]

The first opinion of an Attorney General touching on this question seemed to construe the language of the amendment to Section 6 as exempting from the income tax income derived from restricted allotments.[12] And even without such a clear statutory basis for exemption, a later Attorney General advised that he was—

"[U]nable, by implication, to impute to Congress under the broad language of our Internal Revenue Acts an intent to impose a tax for the benefit of the Federal Government on income derived from the restricted property of these wards of the nation; property the management and control of which rests largely in the hands of officers of the Government charged by law with the responsibility and duty of protecting the interests and welfare of these

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[8] Brief for Petitioner, pages 7–8.
[9] 25 U. S. C. § 349.
[10] See S. Rep. No. 1998, 59th Cong., 1st Sess.; H. R. Rep. No. 1558, 59th Cong., 1st Sess.
[11] This provision was relied upon by Chief Judge Phillips, dissenting in *Jones* v. *Taunah*, 186 F. 2d 445, 449.
[12] 34 Op. Atty. Gen. 275, 281 (1924). And see *id.*, 302 (1924).

dependent people. In other words, it is not lightly to be assumed that Congress intended to tax the ward for the benefit of the guardian." [12]

Two of these opinions were published as Treasury Decisions.[14] On the basis of these opinions and decisions, and a series of district and circuit court decisions, it was said by Felix S. Cohen, an acknowledged expert in Indian law, that "It is clear that the exemption accorded tribal and restricted Indian lands extends to the income derived directly therefrom." [15] These relatively contemporaneous official and unofficial writings are entitled to consideration. The Government makes much of a subsequent Attorney General's opinion,[16] which expressly overruled an earlier opinion,[17] on the authority of *Superintendent of Five Civilized Tribes* v. *Commission*, 295 U. S. 418 [Ct. D. 974, C. B. XIV–1, 158 (1935)].

This case is distinguishable from the case at hand. It involved what the Court characterized as "income derived from investment of surplus income from land," [18] or income on income, which Cohen termed "reinvestment income." The purpose of the allotment system was to protect the Indians' interest and "to prepare the Indians to take their place as independent, qualified members of the modern body politic." *Board of Commissioners* v. *Seber*, 318 U. S. 705, 715. To this end, it is necessary to preserve the trust and income derived directly therefrom, but it is not necessary to exempt reinvestment income from tax burdens. It is noteworthy that the *Superintendent* case did not involve an attempt to tax the land "surplus." [19]

The wisdom of the congressional exemption from tax embodied in Section 6 of the General Allotment Act is manifested by the facts of the instant case. Respondent's timber constitutes the major value of his allotted land. The Government determines the conditions under which the cutting is made.[20] Once logged off, the land is of little value.[21] The land no longer serves the purpose for which it was by treaty set aside to his ancestors, and for which it was allotted to him. It can no longer be adequate to his needs and serve the purpose of bringing him finally to a state of competency and independence. Unless the proceeds of the timber sale are preserved for respondent, he cannot go forward when declared competent with the necessary chance of economic survival in competition with others. This chance is guaranteed by the tax exemption afforded by the General Allotment Act, and the solemn undertaking in the patent. It is unreasonable to infer that in enacting the income tax law, Congress intended to limit or undermine the Government's undertaking. To tax respondent under these circumstances would, in the words of the court below, be "at the least, a sorry breach of faith with these Indians." [22]

The judgment of the Court of Appeals is affirmed.

Mr. Justice Reed dissenting in a separate opinion.

Regulations 118, Section 39.22(b)(2)–5: Employees' annuities.

Determination of amount includible in gross income, under an employees' annuity contract, in the case of a resident United States citizen who had been employed as a bona fide resident of a foreign country. See Rev. Rul. 56–123, page 60.

[12] *Id.*, 439, 445 (1925). This ruling was followed in 35 Op. Atty. Gen. 1 (1925). And *cf. id.*, 107 (1926).

[14] T. D. 3570, III–1 Cumulative Bulletin 85 (1924); T. D. 3754, IV–2 Cumulative Bulletin 37 (1925).

[15] Cohen, Handbook of Federal Indian Law, 265. He distinguished cases permitting the imposition of income taxes upon income derived from unrestricted lands, and upon reinvestment income. *Id.*, at 265–266. Mr. Cohen was Chairman of the Department of Interior Board of Appeals, and Assistant Solicitor of the Department. The Handbook has a foreword by Harold L. Ickes, then Secretary of the Interior, and was printed by the United States Government Printing Office.

[16] 39 Op. Atty. Gen. 107 (1937).

[17] 34 *id.*, 439.

[18] 295 U. S., at 421.

[19] The Government also relies upon *Choteau* v. *Burnet*, 283 U. S. 691 [Ct. D. 352, C. B. X–1, 355 (1931)] but that case also is not controlling, since it held only that a *competent* Indian, who had unrestricted control over lands and income therefrom, was not exempt from income tax solely because of his status as an Indian. Such a tax is specifically authorized by Section 6 of the General Allotment Act.

[20] See *United States* v. *Eastman*, 118 F. 2d 421.

[21] See 220 F. 2d, at 350. In its answer filed in the District Court, the Government admitted that the lands "are generally unsuitable for agricultural purposes . . ." R. 31.

[22] 220 F. 2d 350.

Taxability of amounts distributed under an employees' funded pension or annuity plan in a taxable year of a resident citizen beneficiary beginning after December 31, 1950 and ending before August 17, 1954, on account of personal services rendered outside the United States. See Rev. Rul. 56-125, page 627.

REGULATIONS 118, SECTION 39.22(b)(4)-1: Interest upon state obligations. (Also Part I, Section 103.) Rev. Rul. 56-159

Interest-bearing, special assessment, assignable certificates were issued by a municipality to a contractor in consideration for paving certain streets and alleys. The payments on the certificates are made from special assessments levied against the benefited property owners and not from the general funds or taxes of the municipality. Payments made by the property owners on the special assessments are collected by the city treasurer and tendered to the contractor or other certificate holders. Proper legal steps were taken to levy the special assessment and to establish as valid the liens of which the certificates are evidence. In the event of the foreclosure of a lien, the necessary proceedings are promptly instituted and carried to completion by the city at its own expense. *Held*, the special assessment, assignable certificates constitute the obligation of a political subdivision within the meaning of section 22(b)(4) of the Internal Revenue Code of 1939. Interest on such obligations is, therefore, exempt from Federal income tax. See *Riverview State Bank* v. *Commissioner*, 1 T. C. 1147, acquiescence, C. B. 1945, 6, the cases cited therein; and T. D. 5875, C. B. 1952-1, 15.

SECTION 23(a).—DEDUCTIONS FROM GROSS INCOME: EXPENSES

REGULATIONS 118, SECTION 39.23(a)-1: Business expenses. (Also Sections 39.23(f)-1, 39.23(l)-4.) Ct. D. 1793

INCOME TAX—INTERNAL REVENUE CODE OF 1939—DECISION OF SUPREME COURT

1. DEDUCTIONS FROM GROSS INCOME—BUSINESS EXPENSES—LOSSES—DEPRECIATION.

Where a lessee, the owner of a valuable building on leased land, acquires the fee to the land to be relieved of what it considers to be the burdensome terms of a lease, the lessee may not deduct the excess of the payment over the determined value of the land at the date of purchase as an ordinary expense of doing business under section 23(a) of the 1939 Code or under section 23(f) as a loss. Further, taxpayer-lessee may not amortize the cost allocable to the acquisition of the wasting asset over the term of the extinguished lease.

2. JUDGMENT AFFIRMED.

Judgment of the United States Court of Appeals for the Second Circuit, 221 F. 2d 322, affirmed.

SUPREME COURT OF THE UNITED STATES

Millinery Center Building Corp., petitioner, v. Commissioner of Internal Revenue

On writ of certiorari to the United States Court of Appeals for the Second Circuit

[March 26, 1956.]

OPINION

Mr. Justice Frankfurter delivered the opinion of the Court.

This case involves an interpretation of section 23(a)(1)(A) of the Internal Revenue Code of 1939, providing for the deduction from gross income, in computing net income, of all the "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business. . . ." The Commissioner determined a deficiency in petitioner's excess-profits tax for 1945; petitioner sought a redetermination of its liability in the Tax Court, which made the following findings of fact. In April 1924, petitioner leased land in New York City for 21 years, with an option to renew the lease for two further 21-year periods. In accordance with the terms of the lease, it erected a 22-story loft building at a cost of $3,000,000. The lease, as amended in 1935, provided for an annual rental of $118,840. Title to the building was in petitioner, but at the eventual termination of the lease it would vest, without payment, in the lessor, at the lessor's option. The lessor could also require petitioner to remove the building at that time. Petitioner had the obligation, in case of destruction of the building, to rebuild at its own cost. During the first 21-year period of the lease, petitioner fully depreciated the entire $3,000,000 cost of the building. In April 1945 it exercised its option to renew the lease until April 1966.

In May 1945 petitioner entered into an agreement with the owner whereby it purchased the fee and obtained release from the obligations of the renewed lease. The price paid was $2,100,000. The Tax Court also found that the value of the land, as unimproved, was $660,000 when purchased by petitioner in 1945.

The principal issues raised by petitioner relate to its attempt to deduct $1,440,000—the difference between the purchase price under the May 1945 agreement and the 1945 value of the unimproved land—as an ordinary and necessary expense of doing business. The Tax Court held that the difference could not be so deducted, that the difference could not be amortized over the remaining term of the canceled lease, and that no annual depreciation could be taken because the cost of the building had already been fully depreciated and the purchase price could not be separated into purchase price for building and purchase price for land. 21 T. C. 817. Six of the judges of the Tax Court dissented on the ground that "[s]ome part of the purchase price should be allocated to the additional rights in the building acquired in the purchase. . . ." 21 T. C., at 826.

On petition for review, the Court of Appeals for the Second Circuit reversed and remanded. It affirmed the refusal to permit a deduction under section 23(a), but reversed the holding that no amount could be added to the asset value of the building for purposes of depreciation. Rejecting petitioner's argument that it should be allowed to amortize the $1,440,000 over the unexpired term of the cancelled lease, it accepted petitioner's alternative argument that depreciation over the remaining useful life of the building should be allowed. Stating that "[o]n the present state of the record we cannot determine how much of the $2,100,000 purchase price is properly to be allocated to the land and how much to the building," it remanded the case to the Tax Court to fix the respective values. 221 F. 2d 322, 324. Petitioner sought a writ of certiorari to review the disallowance of its claim for a deduction as a business expense or, alternatively, as amortization over the remaining period of the lease. The Government did not seek review of the allowance of depreciation of that portion of the purchase price allocable to the building over its remaining economic life. Because of the apparent conflict between the decision of the Court of Appeals for the Second Circuit in this case and the decision of the Court of Appeals for the Sixth Circuit in *Cleveland Allerton Hotel, Inc.* v. *Commissioner of Internal Revenue*, 166 F. 2d 805, we granted certiorari, limited to the questions set forth in the margin.[1]

[1] "1. Where a lessee, the owner of a valuable building on leased land, acquires the fee to the land to be relieved of what it considers to be the burdensome terms of a lease, may the lessee deduct the excess of the payment over the determined value of the land at the date of purchase as an ordinary expense of doing business under section 23(a) of the United

Under the terms of the lease, petitioner had a 21-year lease on the land, with an option to renew, and similar rights in the building which it had constructed. Petitioner introduced evidence to show that the rent it was paying under the lease was greatly in excess of the fair rental value of the land as vacant, unimproved land. Petitioner contends that it already owned the building and that therefore the purchase agreement was entered into for the purpose of avoiding the excessive rentals of the lease. This transaction, it asserts, involved a current business expenditure, and the $1,440,000 in excess of the vacant land value represents what it was willing to pay to avoid this onerous lease.

Petitioner's claim that it "owned" the building is based on a loose and misleading use of "owned." The only way petitioner could continue to use the building after termination of the initial period of the lease was by renewing the lease, and the lease also circumscribed its control over the building. It could make use of the building for the remainder of its economic life, but only on payment of the stated rent. Petitioner's evidence with respect to the rental value of the land as unimproved is irrelevant. It was using the land as improved by the building; it was paying rent for the land as improved by the building. Petitioner tendered no evidence that it was paying excessive rent for what it was actually leasing. A complementary feature of the purchase of the lessor's interests in the land and building was the elimination of the obligation to pay rent on the improved land. The purchase price presumably reflected this situation. Whatever possible merit petitioner's contention might have were there proof of excessive purchase price can await such a case. The purchase price paid by petitioner represents the cost of acquiring the complete fee to the land and the building, both capital assets, and no deduction as an ordinary and necessary business expense can be taken.[2]

Petitioner claims that even if it cannot get a deduction as an ordinary and necessary business expense under 23(a) or as a loss under section 23(f), it should be allowed to amortize the excess of the payment of $2,100,000 above the determined land value of $660,000 over the 21-year remaining term of the extinguished lease. What petitioner acquired in this transaction, however, were both rights with respect to the land and rights with respect to the building. The Tax Court has not yet fixed that amount of purchase price which is allocable to the acquisition of rights in the land and that which is allocable to the acquisition of rights in the building. These rights are assets with useful lives having no reference to the term of the lease. Successive steps of securing or renewing a lease and then purchasing the reversion should not result in amortization over the term of the lease when the purchase of the whole fee at one time would result in depreciation over the useful life of the asset, if the asset acquired were a wasting asset.

Under petitioner's contention, if the purchase had been consummated in 1944 before the first term of the lease had expired, the whole amount of the purchase price not allocable to the land would be amortized in one year. But it should make no difference whether the lease is about to expire or has just been renewed. In the one case, the value of the reversion is enhanced and the value of the right to receive the rent fixed by the lease is depressed because the lease is near an end. In the other case, the value of the reversion is depressed and the value of the right to receive the fixed rent is enhanced because the lease has many years to run. But although there might possibly be some difference in bargaining power between the two situations, the sum total of the rights purchased is the same in each case. Petitioner has acquired two assets—land and a building—whose use it will have for the remainder of their useful lives, and petitioner therefore cannot amortize the cost allocable to the acquisition of the wasting asset over the term of the extinguished lease.

Accordingly, we affirm the judgment of the Court of Appeals for the Second Circuit, leaving to the Tax Court the allocation still to be made.

Affirmed.

States Internal Revenue Code of 1939 or under section 23(f) as a loss on a transaction entered into for profit and not compensated for by insurance or otherwise.

"2. In the alternative, may the lessee-petitioner consider the excess payment over the determined value of the land to be in the nature of a prepayment of rent for the remaining term of the extinguished lease and amortize such amount over 21 years?" 350 U. S. 820.

[2] Petitioner asserted, but did not argue, the permissibility of the deduction of the $1,440,000 as a loss under section 23(f). Such an assertion is apparently premised on the assumption that the $1,440,000 represents the sum paid for commutation of the rent payments under an onerous lease, and further discussion of this argument is unnecessary.

"Commitment fees" or "standby charges" paid by a taxpayer pursuant to a bond sale agreement. See Rev. Rul. 56–136, page 92.

Deductibility of payments made in settlement of a suit alleging violation of the Defense Production Act of 1950, 64 Stat. 798, 50 U. S. C. 2061, as amended, where such payments are not certified for disallowance to the Internal Revenue Service by the Economic Stabilization Agency. See Rev. Rul. 56–180, page 94.

SECTION 23(b).—DEDUCTIONS FROM GROSS INCOME: INTEREST

REGULATIONS 118, SECTION 39.23(b)–1: Interest.

"Commitment fees" or "standby charges" incurred in connection with the provisions of a bond sale agreement. See Rev. Rul. 56–136, page 92.

SECTION 23(c).—DEDUCTIONS FROM GROSS INCOME: TAXES GENERALLY

REGULATIONS 118, SECTION 39.23(c)–1: Taxes. Rev. Rul. 56–145

In Delaware, ad valorem taxes on real estate accrue on their due date when liens attach to the property. For taxable years to which the Internal Revenue Code of 1939 is applicable, only the owner of the property at such time is entitled to deduct such taxes when paid or accrued, depending upon the method of accounting employed, irrespective of when the assessment becomes final and whether the assessment antedates a change of ownership.

G. C. M. 23512, C. B. 1943, 134, is revoked.

Reconsideration has been given to G. C. M. 23512, C. B. 1943, 134, in view of the recent decision in *Keil Properties, Inc.* v. *Commissioner*, 24 T. C. No. 123, acquiescence, page 6, this Bulletin.

G. C. M. 23512, *supra*, holds that, in Delaware, real estate taxes are considered to be imposed on a taxpayer on the date the assessment becomes final, irrespective of when they are actually paid.

In the Keil Properties case, the petitioner filed its income tax returns on the accrual basis. The Commissioner, under the authority of G. C. M. 23512, *supra*, contended that the city, school, and county taxes paid by the petitioner in August and September 1949 actually accrued as a liability to the prior owner of the land on April 1, 1949, and April 15, 1949, when assessed, and consequently were not deductible by the petitioner who acquired the property on May 2, 1949, subsequent to the date of assessment. The court held that, in Delaware, county, city, and school taxes accrue on the due date when liens attach to the land. Therefore, the taxpayer was entitled to deduct taxes which became due and payable on July 1, 1949.

The court found that all the reported cases considering the question presented held that where a real estate tax did not become the liability of the seller prior to the date of sale, the purchaser in whose hand the

property subsequently became charged with a lien or who became personally liable for payment of the tax was entitled to deduct the taxes paid by him, notwithstanding that he reported income on the accrual basis and the fact that assessment of the property antedated the change of ownership. See, for example, *Commissioner* v. *Adda, Inc.*, 9 T. C. 199, affirmed 171 Fed. (2) 367, acquiescence, C. B. 1949–1, 1; *Commissioner* v. *Milner Hotels, Inc.*, 173 Fed. (2d) 566; *Commissioner* v. *Lawrence Operating Co.*, 152 Fed. (2d) 938, and *Magruder* v. *Frederick M. Supplee, et ux.*, 316 U. S. 394, Ct. D. 1559, C. B. 1942–1, 173.

Accordingly, it is held that, in Delaware, ad valorem taxes on real estate accrue on their due date when liens attach to the property. For taxable years to which the Internal Revenue Code of 1939 is applicable, only the owner of the property at such time is entitled to deduct such taxes when paid or accrued, depending upon the method of accounting employed, irrespective of when the assessment becomes final and whether the assessment antedates a change of ownership.

G. C. M. 23512, C. B. 1943, 134, is revoked.

SECTION 23(f).—DEDUCTIONS FROM GROSS INCOME: LOSSES BY CORPORATIONS

REGULATIONS 118, SECTION 39.23(f)–1: Losses by corporations.

Lessee-owner of a building on leased land acquiring the fee to the land and obtaining release from the obligations of the renewed lease. See Ct. D, 1793, page 609.

SECTION 23(k).—DEDUCTIONS FROM GROSS INCOME: BAD DEBTS

REGULATIONS 118, SECTION 39.23(k)–5: Reserve for bad debts.

Contributions of mutual savings and other banks to qualified pension plans and trusts which are not deducted in the current year of payment but which are carried forward and deducted in a subsequent year or years. See Rev. Rul. 56–216, page 618.

SECTION 23(l).—DEDUCTIONS FROM GROSS INCOME: DEPRECIATION

REGULATIONS 118, SECTION 39.23(l)–4: Capital sum recoverable through depreciation allowances.

Fee to leased land acquired by a lessee who had constructed a building on the land and had previously recovered his cost. See Ct. D. 1793, page 609.

SECTION 23(m).—DEDUCTIONS FROM GROSS INCOME: DEPLETION

REGULATIONS 118, SECTION 39.23(m)-1: Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements. Ct. D. 1791

INCOME TAX—INTERNAL REVENUE CODE OF 1939—DECISION OF SUPREME COURT.

1. DEDUCTIONS FROM GROSS INCOME—DEPLETION—CALIFORNIA UPLAND OWNERS ON WHOSE LAND "WHIPSTOCK" WELLS HAD BEEN LOCATED TO PRODUCE OIL FROM ADJACENT SUBMERGED LANDS ARE ENTITLED TO DEPLETION ALLOWANCE ON PERCENTAGE OF NET PROFITS RECEIVED BY SUCH OWNERS.

The California State Lands Act requires that all drilling and other operations in connection with extracting oil from submerged state land be done from upland drill sites or filled land. A drilling company, in order to be given a lease by the state of mineral rights to a particular area, obtained from upland owners adjacent to the coastal area, there being no filled land available, the necessary easements over their lands. In return it agreed to pay such owners a percentage of net profits from extraction of oil for the use of their land. *Held*, That the contribution by the upland owners of the use of their land for drilling sites in return for a share of the net profits from production was an investment in the oil in place sufficient to establish an economic interest. Accordingly, the upland owners, rather than the producer, were entitled to depletion on the income received by such owners.

2. JUDGMENTS REVERSED AND AFFIRMED.

Judgment of the United States Court of Appeals for the Ninth Circuit, 220 F. 2d 58, reversed; judgment of United States Court of Claims, 132 F. Supp. 718, affirmed.

SUPREME COURT OF THE UNITED STATES

Commissioner of Internal Revenue and the United States of America, petitioner, v. Southwest Exploration Co. and Huntington Beach Co.

On writ of certiorari to the United States Court of Appeals for the Ninth Circuit and the United States Court of Claims

[February 27, 1956.]

OPINION

MR. JUSTICE CLARK delivered the opinion of the Court.

The Southwest Exploration Co., respondent in No. 286, contracted to develop certain oil deposits lying off the coast of California by whipstock drilling from sites located on the property of adjacent upland owners. Southwest agreed to pay to such owners 24½% of the net profits for the use of their land. Both Southwest and the upland owners sought to take the statutory depletion allowance of 27½% on this share of the profits. The Tax Court decided that Southwest was entitled to the depletion allowance, 18 T. C. 961, and the Ninth Circuit affirmed, 220 F. 2d 58. In the other case, the Court of Claims held that one of the upland owners, Huntington Beach Co., respondent in No. 287, was entitled to the depletion allowance on its share of the net income, 132 F. Supp. 718. We granted certiorari in both cases, 350 U. S. 818, because both the drilling company and the upland owners cannot be entitled to depletion on the same income. We agree with the Court of Claims.[1]

The California State Lands Act of 1938 provided that the State's off-shore oil might be extracted only from wells drilled on filled lands or slant drilled from

[1] In the courts below the Commissioner took technically inconsistent positions, opposing the depletion allowance in both cases and losing in both. Before this Court the Commissioner urged that depletion be denied the drilling company and allowed to the upland owners on the latter's 24½% of net profits.

upland drill sites to the submerged oil deposits.[2] Other provisions of the same statute required that "derricks, machinery, and any and all other surface structures, equipment and appliances" be located only on filled lands or uplands. It was further provided that the state commission might require each prospective bidder for such a state lease to furnish, as a condition precedent to consideration of his bid, satisfactory evidence of "present ability to furnish all necessary sites and rights of way for all operations contemplated under the provisions of the proposed lease."[3]

In 1938 California published notice of its intention to receive bids for the lease of certain oil lands pursuant to this statute. At the time Southwest—a corporation organized in 1933 but completely inactive until the transaction at issue here—did not own, lease, operate or control any of the uplands adjacent to the area of oil deposits. It is agreed that there were no filled lands available. Southwest entered into three agreements with the upland owners, and was granted the right of ingress to and egress from the designated uplands and the right to construct, use and maintain all equipment necessary for drilling on the same lands. The upland owners reserved to themselves the right to give easements or subsurface well crossings in the uplands, except that they would not allow such easements for the purpose of drilling into the off-shore oil deposits while Southwest retained an interest granted to it by state easement. Southwest's rights were expressly subject to all rights previously granted by the upland owners. The agreements defined "net profits" and provided that Southwest would pay a toal of 24½% of its net profits from extraction and sale of oil to the upland owners.[4] It was also provided that the upland owners did not acquire a share in the lease or oil deposit by virtue of the last agreement and that it was not the intention of the parties to create a partnership relationship.

As a result of these agreements, the upland owners endorsed Southwest's bid for a lease submitted to the State of California. Southwest, as the only bidder, was granted "Easement No. 392" by the State in consideration of the "royalty to be paid, the covenants to be performed, and the conditions to be observed by the Grantee." One such condition was that set out in paragraph (1):

> "That each well drilled pursuant to the terms of this agreement shall be slant drilled from the uplands to and into the subsurface of the State lands. Derricks, machinery, and any and all other surface structures, equipment and appliances shall be located only upon the uplands and all surface operations shall be conducted therefrom."

The agreement further provided that if Southwest should "default in the performance or observance of any of the terms, covenants and stipulations hereof" the State might re-enter, cancel the agreement or close down wells not being operated according to the agreement.

The wells drilled pursuant to this lease have produced oil continuously since 1939. In No. 286, *Southwest Exploration Co.*, the tax years 1939 through 1945 are involved. If Southwest may claim the depletion allowance on the upland owner's share of the profits during this period, its tax liability is reduced by approximately $175,000. In No. 287, *Huntington Beach Co.*, the upland owner is claiming a tax refund of $135,000 for the year 1948 alone.[5]

An allowance for depletion has been recognized in our revenue laws since 1913. It is based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit. Presently, the depletion allowance is a fixed percentage of gross income which Congress allows to be excluded; this exclusion is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired. The present allowance, however, bears little relationship to the capital investment, and the taxpayer is not limited to a recoupment of his original investment. The allowance continues so long as minerals are extracted, and even

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[2] Cal. Stat. (extra session 1938), c. 5, § 87.
[3] *Id.*, § 89.
[4] This share was the total of the following percentages of net profits to be paid to the three upland owners:
17.75% to Huntington Beach Company.
1.576% to Pacific Electric Railway Company.
5.174% to Pacific Electric Land Company.
[5] For the tax years 1942 through 1946 Huntington Beach Company claimed and was allowed to deduct depletion on its share of the net profits. The United States is seeking recovery of this money in a suit now pending in the United States District Court for the Northern District of California, Southern Division. The amount at issue there is something over $500,000.

though no money was actually invested in the deposit. The depletion allowance in the Internal Revenue Code of 1939 is solely a matter of congressional grace; it is limited to 27½% of gross income from the property after excluding from gross income "any rents or royalties" paid by the taxpayer with respect to the property.[6]

The complexities of oil operations and risks incident to prospecting have led to intricate, multiparty transactions, so that it is often difficult to determine which parties are entitled to a part of the allowance. The statute merely provides in § 23(m) that in the case of leases the depletion allowance should be "equitably apportioned between the lessor and lessee."

In determining which parties are entitled to depletion on oil and gas income, this Court has relied on two interrelated concepts which were first formulated in *Palmer* v. *Bender*, 287 U. S. 551 [Ct. D. 641, C. B. XII–1, 235 (1933)]. There, the taxpayer, a lessee of certain oil and gas properties, had transferred his interest in these properties to two oil companies in return for a cash bonus, a future payment to be made "out of one-half of the first oil produced and saved," and an additional royalty of one-eighth of the oil produced and saved. In upholding the taxpayer's right to depletion on all such income, the Court based its decision on the grounds that a taxpayer is entitled to depletion where he has: (1) "acquired by investment, any interest in the oil in place," and (2) secured by legal relationship "income derived from the extraction of the oil, to which he must look for a return of his capital." 287 U. S., at 557.

These two factors, usually considered together, constitute the requirement of "an economic interest." This Court has found the requisite interest in the oil in place to have been retained by the assignor of an oil lease, *Thomas* v. *Perkins*, 301 U. S. 655 [Ct. D. 1237, C. B. 1937–1, 162], the lessor of oil properties for a share of net profits, *Kirby Petroleum Co.* v. *Commissioner*, 326 U. S. 599 [Ct. D. 1664, C. B. 1946–1, 69], and the grantor of oil lands considered as an assignor of drilling rights, *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25 [Ct. D. 1674, C. B. 1946–1, 237]. The Court found no such interest in the case of a processor of natural gas who had only contracted to buy gas after extraction, *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362 [Ct. D. 1323, C. B. 1938–1, 306], and in case of a former stockholder who had traded his shares in a corporation which owned oil leases for a share of net income from production of the leased wells, *Helvering* v. *O'Donnell*, 303 U. S. 370 [Ct. D. 1324, C. B. 1938–1, 337].

The second factor has been interpreted to mean that the taxpayer must look *solely* to the extraction of oil or gas for a return of his capital, and depletion has been denied where the payments were not dependent on production, *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372 [Ct. D. 1322, C. B. 1938–1, 293], or where payments might have been made from a sale of any part of the fee interest as well as from production. *Anderson* v. *Helvering*, 310 U. S. 404 [Ct. D. 1456, C. B. 1940–1, 108]. It is not seriously disputed here that this requirement has been met. The problem revolves around the requirement of an interest in the oil in place.

It is to be noted that in each of the prior cases where the taxpayer has had a sufficient economic interest to entitle him to depletion, he has once had at least a fee or leasehold in the oil-producing properties themselves. No prior depletion

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[6] Pertinent sections of the Internal Revenue Code of 1939 provide:

"SEC. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

. . . . . .

"(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. . . . In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. . . . (For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).)

"SEC. 114. Basis for Depreciation and Depletion.

"(b) Basis for Depletion.

. . . . . .

"(3) Percentage depletion for oil and gas wells. In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph."

case decided by this Court has presented a situation analogous to that here, where a fee owner of adjoining lands necessary to the extraction of oil is claiming a depletion allowance.

Southwest contends that there can be no economic interest separate from the right to enter and drill for oil on the land itself. Since the upland owners did not themselves have the right to drill for off-shore oil, it is argued that respondent—who has the sole right to drill—has the sole economic interest. It is true that the exclusive right to drill was granted to Southwest, and it is also true that the agreements expressly create no interest in the oil in the upland owners. But the tax law deals in economic realities, not legal abstractions, and upon closer analysis it becomes clear that these factors do not preclude an economic interest in the upland owners.

Southwest's right to drill was clearly a conditional rather than an absolute grant. Without the prior agreements with the upland owners, Southwest could not even have qualified as a bidder for a state lease. Permission to use the upland sites was the express condition precedent to the State's consideration of Southwest's bid, and it was one of the express conditions on which "Easement No. 392" was granted to Southwest. For a default in that condition the State retained the right to re-enter or to cancel the lease. Thus it is seen that the upland owners have played a vital role at each successive stage of the proceedings. Without their participation there could have been no bid, no lease, no wells and no production.

But Southwest contends that the upland owners here contributed merely property which was useful but not necessary to the drilling operation. The facts are to the contrary. State law required that the wells be drilled either on the uplands or on filled lands, and there were no filled lands available. By hindsight Southwest now suggests that it might have constructed a drilling island which might have been considered as filled land under the statute. Then, too, perhaps the State itself might have changed the law or condemned the uplands under existing law. But none of these possibilities occurred. The fact is that the drilling arrangement was achieved and oil produced in the only way that it could have been, consistent with state law and the express requirements of the State's lease.

Recognizing that the law of depletion requires an economic rather than a legal interest in the oil in place, we may proceed to the question of whether the upland owners had such an economic interest here. We find that they did. Proximity to the off-shore oil deposits and effect of the state law combined to make the upland owners essential parties to any drilling operations. This controlling position greatly enhanced the value of their land when extraction of oil from the State's off-shore fields became a possibility. The owners might have realized this value by selling their interest for a stated sum and no problem of depletion would have been presented. But instead they chose to contribute the use of their land in return for rental based on a share of net profits. This contribution was an investment in the oil in place sufficient to establish their economic interest. Their income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced. No more is required by any of the earlier cases.

Southwest contends, finally, that if depletion is allowed to the upland owners in this case, it would be difficult to limit the principle in instances of strangers "disassociated from the lease" who may have contributed an essential facility to the drilling operation in return for a share of the net profits. But those problems are not before us in this case where the upland owners could hardly be said to be "disassociated from the lease." We decide only that where, in the circumstances of this case, a party essential to the drilling for and extraction of oil has made an indispensable contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received.

For the foregoing reasons the judgment in No. 286, as to Southwest Exploration Company, is reversed and that in No. 287, as to Huntington Beach Company, is affirmed.

No. 286, Reversed.

No. 287, Affirmed.

MR. JUSTICE DOUGLAS dissents.

MR. JUSTICE HARLAN took no part in the consideration or decision of these cases.

REGULATIONS 118, SECTION 39.23(m)-5: Computation of depletion based on percentage of income in case of certain mines or other natural deposits.

Definition of "refractory and fire clay" for percentage depletion cases. See Rev. Rul. 56-59, page 626.

REGULATIONS 118, SECTION 39.23(m)-10: Depletion; adjustments of accounts based on bonus or advanced royalty.

Treatment of first year "rental" payments paid in the acquisition of noncompetitive government oil and gas leases. See Rev. Rul. 56-252, page 210.

SECTION 23(p).—DEDUCTIONS FROM GROSS INCOME: CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN

REGULATIONS 118, SECTION 39.23(p)-1: Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan; in general. (Also Sections 23(k), 39.23(k)-5; Section 437; Regulations 130, Section 40.437-3.) — Rev. Rul. 56-216

The amount of a contribution for past services made to a pension plan or trust qualified under section 165(a) of the Internal Revenue Code of 1939 which, due to the limitations of section 23(p)(1)(A) of the Code, is not deductible in the current year of payment, but which may be carried forward and deducted in a subsequent year or years, does not constitute an asset of the taxpayer for equity capital purposes under section 437(c) of the Code. A similar amount in the case of a mutual savings bank is not considered to be an asset of the bank for the purpose of determining surplus, undivided profits, or reserves under section 23(k) of the Code.

Advice has been requested whether the amount of a contribution for past services to a pension plan or trust qualified under section 165(a) of the Internal Revenue Code of 1939 which, due to the limitations of section 23(p)(1)(A) of the Code, is not deductible in the current year, but which may be carried forward and deducted in a subsequent year or years, constitutes an asset of the taxpayer for equity capital purposes under section 437(c) of the Code. Advice has also been requested whether a similar amount in the case of a mutual savings bank is considered to be an asset for the purpose of determining surplus, undivided profits, or reserves under section 23(k) of the Code.

Section 23(p) of the Code provides, in part, that an employer's contribution to or under a pension plan shall be deductible in the taxable year when paid, except that amounts paid in excess of certain specified limitations shall be deductible in the succeeding taxable years to the extent of the difference between the amount paid and deductible in such succeeding year and the maximum amount deductible for such year in accordance with the specified limitations.

Section 23 (k) (1) of the Code provides, in part, that 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 shall in no case be less than the amount determined as the reasonable addition for such year, except that the amount determined shall not be greater than the lesser of (A) the amount of net income for the tax year, or (B) the amount by which 12 percent of the total deposits or withdrawable accounts at the close of the year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.

Section 437(c) of the Code provides that, for excess profits tax purposes, the equity capital of the taxpayer shall be the total assets held for the purposes of the business reduced by the total of its liabilities, and that, with certain exceptions not pertinent here, the adjusted basis of each asset shall be the adjusted basis for determining gain upon sale or exchange. Section 40.437–5(b) (1) of Regulations 130 further provides that, in general, section 113 of the Code and the regulations prescribed thereunder are the pertinent provisions relating to adjusted basis of assets.

Prior to 1942, lump-sum, non-trusteed payments by an employer to purchase annuities based on past service were deductible in full in the year paid, as a business expense, under section 23(a) of the Code, if such payments did not exceed a reasonable compensation for services rendered. See I. T. 2910, C. B. XIV–2 (1935), 152. Thus, for the years prior to 1942 such lump-sum payments were not capitalized and amortized ratably over subsequent years.

Under the Revenue Act of 1942, lump-sum payments to a nontrusteed plan were treated in the same manner as payments to trusteed plans and prorated over a period of years. However, this change cannot in any manner be construed as creating an asset out of such expenditure.

Deductions under the Internal Revenue Code are matters of legislative grace. The fact that Congress has seen fit to limit the deductibility of an expenditure in no way converts that expenditure or any portion thereof into an asset. For example, accountingwise, it may be noted with respect to a net capital loss of a corporation that the income is reduced in the year the loss is sustained; yet, for tax purposes, no deduction is allowable for a net capital loss. In a later year, such loss may be availed of to reduce income for tax purposes; however, the loss in no sense may be considered as an asset.

The mere fact that by reason of the funding of benefits for past services the taxpayer obtains an economic benefit through increased employee retention and efficiency, reflected over the future years, does not create an asset. Similar benefits are obtained by a taxpayer through liberal employee remuneration policies, yet such expenditures in no way create an asset for Federal tax purposes.

Accordingly, it is held that the amount of a contribution for past services made to a pension plan or trust qualified under section 165(a) of the Code which, due to the limitations of section 23(p) (1) (A) of the Code, is not deductible in the current year of payment, but which may be carried forward as a deduction in a subsequent year or years,

does not constitute an asset of the taxpayer for equity capital purposes under section 437(c) of the Code nor, in the case of a mutual savings bank, an asset for the purpose of determining surplus, undivided profits, or reserves under section 23(k) of the Code.

SECTION 23(s).—DEDUCTIONS FROM GROSS INCOME: NET OPERATING LOSS DEDUCTIONS

Adjustment for excessive depreciation taken for the taxable year in which a net operating loss originated. See Rev. Rul. 56-285, page 134.

SECTION 24(a).—ITEMS NOT DEDUCTIBLE: GENERAL RULE

REGULATIONS 118, SECTION 39.24(a)-6: Taxes and carrying charges chargeable to capital account and treated as capital items.

"Commitment fees" or "standby charges" capitalized as part of construction costs. See Rev. Rul. 56-136, page 92.

Election to capitalize insurance premiums on a construction loan attributable to the loan during the period of construction of improvements covered by the loan. See Rev. Rul. 56-264, page 153.

PART IV.—ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

SECTION 42.—PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED

Regulations 118, Section 39.42-2: Income not reduced to possession.
(Also Section 117(f).) Rev. Rul. 56-77

A taxpayer who, prior to the maturity date of a face-amount certificate issued by Investors Syndicate of America, Inc., elects to make further payments and extends the maturity date of the certificate does not constructively receive, in the year such certificate would have originally matured, the amount which represents the difference between the cost of the certificate and its maturity value on that date.

Where the holder of an Accumulative Installment Certificate elects, prior to maturity, to be paid the proceeds of the certificate in installments, the holder thereof is not in constructive receipt of the total amount of the proceeds of the certificate on the maturity date and is not taxable upon any amount until he has first recovered the total amount paid for such certificate. Any amounts received upon redemption of certificates purchased during the period beginning December 25, 1944, and ending December 31, 1954, will, to the extent that they exceed the amount paid for such certificate, constitute capital gain within the meaning of section 117(f) of the Internal Revenue Code of 1939. Where the certificate was purchased prior to December 25, 1944, any amount received in excess of the cost of the certificate constitutes ordinary income.

Advice has been requested with respect to the effect, for Federal income tax purposes, of the exercise by a taxpayer of certain options contained in investment certificates issued prior to January 1, 1955, by Investors Syndicate of America, Inc., and its parent corporation. Particularly, the questions relate to a taxpayer's election prior to maturity to receive the matured value of the installments over a period of years and to the taxpayer's election to extend the original maturity date.

In the instant case, the taxpayer purchased Term Installment Face-amount Investment Certificates from Investors Syndicate of America, Inc., an investment company within the meaning of the Investment Company Act of 1940, 54 Stat. 789, 15 U. S. C. 80. Such certificates are face-amount certificates as defined in section 2(a)(15) of the Act, 15 U. S. C. 80a-2. Investors Syndicate markets several series of installment type certificates which differ only in the length of time over which installment payments are made by an investor. The contracts under which the certificates were sold provide for monthly, quarterly, semi-annual, or annual payments by the purchaser of stipulated amounts over the life of the certificates. Upon maturity, the holder is entitled to receive the stated face amount of the certificate or may leave the matured value with the company for a period not in excess of 20 years and receive the aggregate accumulated interest and principal at the end of the 20-year period, or earlier, if he so elects. He may elect, prior to maturity, to receive the matured value in term installment payments over a period of four years or more, or to extend the certificate for an additional period of years during which the normal periodic payments will continue and at the end of the extended term he will receive an amount greater than the original face value of the certificate.

The acquiescence, C. B. 1944-5, has been withdrawn in the case of *Commissioner* v. *George Peck Caulkins*, I. T. C. 656, affirmed 144 Fed. (2d) 482, wherein it was held that the excess amount received by the taxpayer, pursuant to a contract with Investors Syndicate, over the aggregate payments made by him for Accumulative Installment Certificates constitutes capital gain within the meaning of section 117(f) of the Internal Revenue Code of 1939. However, the change in position of the Internal Revenue Service (disclosed by the nonacquiescence, C. B. 1955-1, 7, in the Caulkins case) was to be applied without retroactive effect to any amounts received upon redemption of Accumulative Installment Certificates purchased during the period beginning December 25, 1944, the date acquiescence in the Caulkins case was announced, and ending December 31, 1954. See Revenue Ruling 119, C. B. 1953-2, 95, as modified by Revenue Ruling 55-136, C. B. 1955-1, 213, as amended by the special announcement published in I. R. B. 1955-38, 28.[1]

Section 42 of the 1939 Code provides that the amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer unless, under methods of accounting permitted under section 41 of that Code, any such amounts are to be properly accounted for as of a different period.

Section 39.42-2 of Regulations 118 provides the general rules for applying the principle of constructive receipt, as follows:

[1] See Revenue Ruling 56-299, page 603 of this Bulletin, superseding Revenue Ruling 55-136 as so modified.

INCOME NOT REDUCED TO POSSESSION.—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment, or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

Under the principle of constructive receipt, a taxpayer is deemed to have received income which is definitely limited with respect to amount and which is available to him without restriction or is set aside or credited to him. See section 39.42–3 of Regulations 118 for examples of constructive receipt.

I. T. 3963, C. B. 1949–2, 36, holds that the purchaser of an endowment policy who, prior to the maturity date, notifies the insurer of his election to receive the proceeds in installments does not constructively receive the total amount of the proceeds on the date of maturity. That ruling is not to be distinguished from the instant case merely because it deals with an insurance policy, but it is considered relevant and pertinent in deciding the constructive receipt question here involved.

Accordingly, it is held that a taxpayer who, prior to the maturity date of a face-amount certificate issued by Investors Syndicate, elects to make further payments and extends the maturity date of the certificate does not constructively receive, in the year such certificate would have originally matured, the amount which represents the difference between the cost of the certificate and its maturity value on that date.

Where the holder of an Accumulative Installment Certificate elects, prior to maturity, to be paid the proceeds of the certificate in installments, the holder thereof is not in constructive receipt of the total amount of the proceeds of the certificate on the maturity date and is not taxable upon any amount until he has first recovered the total amount paid for such certificate. Any amounts received upon redemption of certificates purchased during the period beginning December 25, 1944, and ending December 31, 1954, will, to the extent that they exceed the amount paid for such certificate, constitute capital gain within the meaning of section 117(f) of the 1939 Code. Where the certificate was purchased prior to December 25, 1944, any amount received in excess of the cost of the certificate constitutes ordinary income.

SECTION 44.—INSTALLMENT BASIS

REGULATIONS 118, SECTION 39.44–1: Sale of personal property on installment plan.

Dividends paid on shares of stock sold and held in trust applied as payments against interest and principal of promissory note given for purchase of the stock. See Rev. Rul. 56–153, page 166.

SUBCHAPTER C.—SUPPLEMENTAL PROVISIONS

SUPPLEMENT A.—RATES OF TAX

SECTION 101.—EXEMPTIONS FROM TAX ON CORPORATIONS

REGULATIONS 118, SECTION 39.101(14)-1:
Corporations organized to hold title to property for exempt organizations.

Reorganized railroad company whose bonds and outstanding common stock are owned by the Reconstruction Finance Corporation. See Rev. Rul. 56-93, page 601.

SECTION 107.—COMPENSATION FOR SERVICES RENDERED FOR A PERIOD OF THIRTY-SIX MONTHS OR MORE AND BACK PAY

REGULATIONS 118, SECTION 39.107-1: Personal services. Rev. Rul. 56-210

For the purposes of section 107(a) of the Internal Revenue Code of 1939, a husband and wife who reside in a noncommunity property state may split income received after December 31, 1947, and before March 1, 1954, which constitutes compensation received by the husband for personal services rendered by him during taxable years ending before January 1, 1948.

Revenue Ruling 54-206, C. B. 1954-1, 94, revoked.

Reconsideration has been given by the Internal Revenue Service to the position set forth in Revenue Ruling 54-206, C. B. 1954-1, 94, in the light of various court decisions on that issue.

Revenue Ruling 54-206, *supra*, states the position of the Service to be that, for the purposes of section 107(a) of the Internal Revenue Code of 1939, a husband and wife who reside in a noncommunity property state may not split income which constitutes compensation received by the husband for personal services rendered by him during taxable years beginning prior to January 1, 1948 (the effective date of section 12(d) of the 1939 Code which permitted income-splitting between husbands and wives). All of the following court decisions, however, hold contrary to the position taken in Revenue Ruling 54-206, *supra: Hofferbert* v. *R. E. Lee Marshall et ux.*, 200 Fed. (2d) 648; *Commissioner* v. *Ayers J. Stocky et ux.*, 221 Fed. (2d) 745; *United States* v. *Arthur B. Koontz et ux.*, 223 Fed. (2d) 250; *John E. McClure et ux.* v. *United States*, 228 Fed. (2d) 322; *Commissioner* v. *Benjamin Mahler et ux.*, 228 Fed. (2d) 903; *Leon R. Jillson et ux.* v. *Commissioner*, 22 T. C. 1101, nonacquiescence in part, C. B. 1955-1, 7; *William G. Boatright et ux.* v. *United States*, 135 Fed. Supp. 93; *Richard B. Barker et ux.* v. *United States* (D. C. Md., 1955, unreported); and *Caleb R. Layton, III, et ux.* v. *United States* (D. C. Del., 1956, unreported).

The position of the Service on this issue as set forth in Revenue Ruling 54-206, *supra*, has been incorporated in section 1305(c) of the

Internal Revenue Code of 1954 and made effective by section 1305(d) of the 1954 Code as to amounts received or accrued after March 1, 1954. Consequently, this issue will only arise in connection with section 107(a) income received on or after January 1, 1948, and before March 1, 1954. However, in view of the court decisions contrary to the position of the Service on this issue, the Service will follow such decisions in those cases in which section 107(a) of the 1939 Code is applicable. Revenue Ruling 54–206, *supra*, is revoked.

The Service further concedes that, in view of the decisions in *Commissioner* v. *Ayers J. Stockly et ux.*, *supra*, and *George K. Ford et ux.* v. *Commissioner*, 217 Fed. (2d) 886, the computation under section 107(a) of the 1939 Code may be made on a separate return basis for the years during which section 107(a) income was earned, despite the fact that joint returns may have been filed for the prior years.

SECTION 112(b).—RECOGNITION OF GAIN OR LOSS: EXCHANGES SOLELY IN KIND

REGULATIONS 118, SECTION 39.112(b)(7)–1: Corporate liquidation in calendar month in 1952.

Gain on subsequent sale by stockholders of real property received in a corporate liquidation in 1952. See Rev. Rul. 56–160, page 633.

SECTION 112(f).—RECOGNITION OF GAIN OR LOSS: INVOLUNTARY CONVERSION

REGULATIONS 118, SECTION 39.112(f)–1: Involuntary conversion where disposition of the converted property occurred after December 31, 1950. — Rev. Rul. 56–300

A taxpayer made an application for an extension of time within which to replace involuntarily converted property, but such application was not made within the one-year period provided by section 112(f)(3)(B)(i) of the Internal Revenue Code of 1939. *Held*, the granting of such extension is not prohibited by section 39.112(f)–1(c)(3) of Regulations 118 provided the taxpayer can show reasonable cause why the application for an extension of time was not made within the period specified by the regulations. See section 39.6000–1, of Regulations 118.

SECTION 113(a).—ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS: BASIS (UNADJUSTED) OF PROPERTY

REGULATIONS 118, SECTION 39.113(a)–2: General rule. — Rev. Rul. 56–100

The basis of assets acquired by a corporation in a taxable exchange for its stock is the fair market value of the stock used to purchase the assets, and not the underlying fair market value of the assets transferred.

Revenue Ruling 54–96, C. B. 1954–1, 111, modified.

The Internal Revenue Service has been requested to reconsider the basis of the stock and assets exchanged in Revenue Ruling 54–96, C. B. 1954–1, 111.

Under the facts presented in Revenue Ruling 54–96, *supra*, *X* corporation organized a new corporation *Y*, transferring part of its assets in exchange for all stock of *Y*. *X* thereafter, as part of a prearranged plan, transferred all of the stock of *Y* to an unrelated corporation, *Z*, in exchange for which *Z* issued to *X* 20 percent of *Z's* voting stock.

The Service held that the two steps were part of a prearranged, integrated plan and may not be considered independently of each other. Consequently, since *X* corporation was not in control of the *Y* corporation after transferring a part of its assets to that corporation, it did not constitute a reorganization as defined in section 112(g)(1) of the Internal Revenue Code of 1939, nor did it constitute a tax-free transfer under section 112(b)(5) of such Code.

At issue are the last two sentences of said Revenue Ruling which read as follows:

> The basis of the stock of *Y* in the hands of *Z* will be its fair market value at the time it is received by *Z*. The basis to *Y* corporation of the assets received by *Y* will be their fair market value at the time of receipt.

The above-quoted statements in Revenue Ruling 54–96, *supra*, relating to the basis of the *Y* stock in the hands of *Z* and the basis of the assets received by *Y*, are based on the assumption that the three parcels of property involved (the assets transferred to *Y*, the *Y* stock, and the *Z* stock) all have the same fair market value. The quoted statements are not applicable to any case in which this assumption is incorrect.

The Code provides that the basis of assets to a purchaser is his cost, which in this case is the fair market value of stock issued for the assets. Evidence as to the fair market value of the assets received is admissible to show the fair market value of the stock used in making the acquisition, but is of less weight than available direct evidence of the fair market value of such stock. Since the prior ruling may give the impression that evidence as to the fair market value of the assets is directly controlling, the last two sentences of Revenue Ruling 54–96, *supra*, are hereby revised to read as follows:

> Under the facts of the instant case the basis to *Y* of the assets of *X* received by it and the basis to *Z* of the *Y* stock will both be the same as the fair market value of the *Z* stock received by *X*.

Revenue Ruling 54–96 is modified accordingly.

REGULATIONS 118, SECTION 39.113(a)(13)-2: Readjustment of partnership interest.

Annual assessments to replenish capital of the partnership should be added to the partner's basis of his interest in the partnership. See Rev. Rul. 56–5, page 630.

SECTION 114.—BASIS FOR DEPRECIATION AND DEPLETION

REGULATIONS 118, SECTION 39.114–1: Basis for allowance of depreciation and depletion. (Also Section 23(m), Section 39.23(m)–5.) Rev. Rul. 56–59

A clay will be considered a refractory and fire clay only if it is used or sold for use for a recognized refractory purpose. Revenue Ruling 54–550, C. B. 1954–2, 164, revoked.

The Internal Revenue Service has reconsidered the definition of "refractory and fire clay" as stated in Revenue Ruling 54–550, C. B. 1954–2, 164.

Revenue Ruling 54–550, *supra*, defines "refractory and fire clay" as a clay having a pyrometric cone equivalent of 15 or higher. It also holds that a clay having a pyrometric cone equivalent of less than 15 will not be considered a refractory or fire clay unless used or sold for recognized refractory purposes, such as (but not necessarily restricted to) ladle lining.

A number of minerals accorded percentage depletion, for example, brick and tile clay, stone, and calcium carbonates, are capable of being placed in more than one percentage depletion classification for the reason that they have no precise mineralogical description to distinguish them from certain other minerals in a higher or lower percentage depletion classification. Therefore, in order to distinguish and classify such minerals for the purpose of percentage depletion it is necessary to employ the end-use test. See Rev. Rul. 54–443, C. B. 1954–2, 164, with respect to quartzite; Rev. Rul. 55–67, C. B. 1955–1, 357 with respect to gypsum; and Rev. Rul. 55–700, C. B. 1955–2, 569, with respect to dolomite.

In the case of clay, it has been found that in some parts of the United States the clay ordinarily used for the manufacture of common brick and tile has a cone equivalent in excess of 15. On the other hand, it is recognized that under certain circumstances fire clay may be used in conjunction with ordinary clay and still be used for refractory purposes, such as, when a certain amount of fire clay is blended with ordinary clay in order to produce the vitrified clay sewer pipe which requires some clay of a better quality than the ordinary tile.

In view of the above, it follows that in determining the percentage depletion applicable to clay the end-use test must be employed. For example, clay used or sold for use in the manufacture of common bricks is entitled to 5 percent depletion, while clay used or sold for use as refractory clay is entitled to 15 percent depletion.

Accordingly, a clay will be considered a "refractory and fire clay" only if it is used or sold for use for a recognized refractory purpose. In this connection, fire clays used to enable sewer pipe to retain its shape and dimensions under extremely high temperatures required for vitrification is considered to be used as refractory clay.

Revenue Ruling, 54–550, C. B. 1954–2, 164, is hereby revoked.

SECTION 115(a).—DISTRIBUTIONS BY CORPORATIONS: DEFINITION OF DIVIDEND

REGULATIONS 118, SECTION 39.115(a)-1: Dividends.

Amount paid on shares of stock sold and held in trust applied as payments against principal of a promissory note given for the purchase of other stock. See Rev. Rul. 56-153, page 166.

SECTION 116.—EXCLUSIONS FROM GROSS INCOME

REGULATIONS 118, SECTION 39.116-1: Earned income from sources without the United States. (Also Section 22(b), Section 39.22(b)(2)-5.) Rev. Rul. 56-125

For taxable years beginning after December 31, 1950, and subject to the Internal Revenue Code of 1939, annuity payments made to a resident citizen beneficiary, under an employees' funded pension or annuity plan which meets the requirements of section 165(a) of the 1939 Code, to the extent they represent the employer's contribution under the plan on account of the employee's services during an uninterrupted period (which includes an entire taxable year) of bona fide residence in a foreign country or countries, may be considered as earned income attributable to such period within the meaning of section 116(a)(1) of the Code and, as such, may be excluded from gross income as "consideration paid" for the annuity under section 22(b)(2)(B). However, that portion of the annuity payments which represents the earnings on or accretions to contributions of either employer or employee is not earned income within the purview of section 116(a) of the Code and therefore not exempt under such section.

Advice has been requested as to the taxability, to the distributee, of amounts distributed or made available under an employer's funded pension or annuity plan for the benefit of his employees, if the amounts were on account of service rendered by a United States citizen as a bona fide resident of a foreign country, and were distributed or made available in a taxable year of the distributee, beginning after December 31, 1950, and subject to the Internal Revenue Code of 1939 (see section 7851(a)(1)(A) of the 1954 Code), at a time when the citizen-distributee was residing in the United States.

An employer has, for many years, maintained a pension plan covering all his employees. The plan was funded through a group annuity contract with an insurance company. Employees contribute to the plan according to salary brackets and the balance of the cost of the annuities is paid by the employer. The Internal Revenue Service has held the plan meets the requirements of section 165(a)(3), (4), (5), and (6) of the Internal Revenue Code of 1939.

In the instant case, the entire amount of the employee's annuity is based on service rendered in foreign countries during an uninterrupted period of bona fide residence in those countries for 30 years. Upon retirement in 1945, the taxpayer returned and resumed residence in the United States.

Annuities or pensions paid under a nontrusteed plan which meets the requirements of section 165(a)(3), (4), (5), and (6) of the Code

are taxable to the annuitant as provided in section 22(b)(2)(B) of the Code. However, due consideration must also be given to sections 116, 117, and 119 of the Code.

Amounts received as an annuity, under an annuity contract, shall be included in gross income in accordance with section 22(b)(2) of the Code. There shall be excluded, however, the excess of the amount received in the taxable year over an amount equal to three percent of the aggregate premiums or consideration paid for such annuity, until the aggregate amount excluded from gross income equals the aggregate premiums or consideration paid for such annuity, after which all amounts received shall be included in gross income.

In addition to the items specified in section 22 (b) of the Code, section 116(a)(1) of the Code, as amended by the Revenue Act of 1951, 65 Stat. 452, provides that there shall be excluded from gross income, in the case of an individual citizen of the United States who establishes bona fide residence in 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 paragraph (3) of section 116(a) of the Code, attributable to such period.

Treasury Decision 6039, C. B. 1953–2, 162, amended Regulations 111, section 29.116–1(a), and held that for taxable years beginning after December 31, 1950, the exemption from tax provided by section 116(a) of the 1939 Code is applicable to amounts constituting earned income, as defined in section 116(a)(3), from sources without the United States, if not paid by the United States or any agency or instrumentality thereof, and if attributable to an uninterrupted period of bona fide foreign residence which includes an entire taxable year or attributable to that portion of such an uninterrupted period which falls within a taxable year during the course of which the citizen begins or terminates bona fide residence in a foreign country, provided that such period includes at least one taxable year. If attributable to an uninterrupted period in respect to which the citizen qualifies for the exemption from tax thus provided, the amounts shall be excluded from gross income irrespective of when they are received, if received in taxable years beginning after December 31, 1950.

Treasury Decision 6039, *supra*, also held, in effect, that an amount constituting earned income, as defined in section 116(a)(3) of the 1939 Code, which is derived from sources without the United States, shall not be included in gross income solely because it is received within the United States, since the place of receipt is immaterial in determining whether any items shall be excluded from gross income under the provisions of section 116(a). No amounts received for services performed within the United States shall be excluded from gross income by such section. For the allocation or segregation as between sources within, and sources without, the United States in the case of compensation for labor or personal services, see section 119 of the 1939 Code and regulations thereunder.

Earned income as defined in section 116(a)(3) of the Code means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered. However, see IR-Mim. 71, C. B. 1952–2, 170, which states that the portion of any dis-

tribution from an annuity or pension plan which represents a return of the employee's own contributions may not be properly classed as earned income within the meaning of section 116(a)(3) of the Code, and that to the extent such distributions represent earnings on and accretions to contributions of either the employer or the employee, they constitute income from sources within the United States and accordingly are includible in gross income.

Since, in the instant case, the bona fide residence in a foreign country was continuous and uninterrupted for a period of 30 years, the annuity payments received in taxable years beginning on and after January 1, 1951, may be excluded from gross income in the manner provided in section 22(b)(2)(B) of the Code, to the extent they constitute earned income, within the meaning of section 116(a)(3) of the Code, attributable to such period.

Beginning in 1945, the taxpayer treated the annuity payments in the manner provided in section 22(b)(2)(B) of the Code and thereby, prior to January 1, 1951, recovered tax-free all of his own contributions toward the cost of the annuity as consideration paid for such annuity. However, in determining the amount of the annuity payments received under the employer's annuity plan in any taxable year beginning on or after January 1, 1951, which must be included in gross income pursuant to section 22(b)(2)(B) of the Code, the "consideration paid" for such annuity would be the aggregate of the employee's contribution plus the amounts contributed by the employer which are attributable to services rendered as a bona fide resident of a foreign country or countries. Since the employee's own contributions have already been recovered tax-free, the amount remaining to be recovered tax-free in taxable years beginning after December 31, 1950, will in this case, be limited to the employer's contribution attributable to the services rendered as a bona fide resident of a foreign country or countries.

Accordingly, it is held that for taxable years beginning after December 31, 1950, and subject to the Internal Revenue Code of 1939, annuity payments made to a resident citizen beneficiary, under an employees' funded pension or annuity plan which meets the requirements of section 165(a) of the Code, to the extent they represent the employer's contribution under the plan on account of the employee's services during an uninterrupted period (which includes an entire taxable year) of bona fide residence in a foreign country or countries, may be considered as earned income attributable to such period within the meaning of section 116(a)(1) of the Code and, as such, may be excluded from gross income as "consideration paid" for the annuity under section 22(b)(2)(B). However, that portion of the annuity payments which represents the earnings on or accretions to contributions of either employer or employee is not earned income within the purview of section 116(a) of the Code and therefore not exempt under such section.

(Also Regulations 111, Section 29.116-1.)

Amounts received from employees' annuities for service rendered as a bona fide resident of a foreign country for a domestic corporation. See Rev. Rul. 56-123, page 60.

REGULATIONS 118, SECTION 39.116–2: Income of foreign governments, international organizations, and their employees.

Taxability of pensions to former employees of foreign governments. See Rev. Rul. 56–44, page 319.

SECTION 117(a).—CAPITAL GAINS AND LOSSES: DEFINITIONS

REGULATIONS 118, SECTION 39.117(a)–1: Meaning of terms. Rev. Rul. 56–5

(Also Section 113(a)(13); Section 39.113(a)(13)–2.)

Goodwill units created by a partnership agreement constitute an integral and indivisible part of a partner's capital investment, and annual assessments paid by a partner to replenish the partnership capital based on his share of the firm's earnings are capital contributions which increase the basis of the partnership interest provided that the income tax is paid thereon. Any gain or loss realized upon the partial or complete liquidation of an individual's partnership interest, a capital asset, is capital in nature and is measured by the difference between the amount received for the partnership interest or portion thereof and the basis of such interest or portion thereof.

Advice has been requested with respect to the treatment of a partnership interest when a partner partially or completely retires from the partnership under the circumstances presented below.

The interest of each partner in the instant partnership is expressed in units owned by him. At one time the partnership articles provided for subdivision of partnership units into capital and goodwill units. Accordingly, some of the partners own partnership units consisting of both capital and goodwill units while others own only capital units. The subdivision was used to measure the partnership interest of a withdrawing partner. By later amendments to the articles, the partnership goodwill was recorded on the firm's book at a nominal amount and henceforth was regarded as a partnership asset having no value for purposes of determining the value of the member's partnership interest. In order to replenish the firm's capital after a large amount had been paid to the estate of a deceased partner, the partners agreed to provide additional working capital by annual assessments based on the number of partnership units held by each. The assessments were credited to an "intangible asset" account and represented a proportionate part of each partner's share of the firm's profit.

After having paid the assessment for two years, the taxpayer, who was a partner in the firm, partially retired. One of the above assessments was paid for the year of his partial retirement. Pursuant to the provisions of the articles then in force, he received from the firm cash and cash equivalents constituting his distributive share of the partnership net income for the taxable year of his partial retirement and consideration for the liquidation of two-thirds of the units representing his partnership interest. No part of the amount received by the partner in consideration of the liquidation of a portion of his partnership interest was attributable to firm earnings not yet subjected to tax whether realized or unrealized by the firm prior to such liqui-

dation. The remaining one-third of his units continue to be subject to the risks and profits of the business for five years and he is obliged to pay annual assessments computed on the basis of his reduced profits share. Pursuant to the partnership agreement, the partner received nothing with respect to his investment in goodwill units nor with respect to the annual assessments paid by him.

The partner's goodwill units were not separate investments in and of themselves which he could dispose of without affecting his capital units but both constituted an integral and indivisible part of his partnership interest. The cost of such goodwill units to a partner is not separately deductible by him in whole or in part upon partial or complete liquidation of his partnership interest. Such cost, however, is reflected in the cost of his partnership interest and is part of the basis therefor. The annual assessments which he paid are not deductible by him. Since the purpose of those payments was to replenish the firm's working capital, they are capital contributions, that is, capital expenditures for the partnership interest. As such, they are a part of his partnership interest even though they can be reflected in the liquidation value of such interest only upon termination of the firm and not upon his retirement. Since these annual asessments are a part of the member's partnership interest, there can be no depreciation with respect to them.

Upon his partial or complete retirement, the member realizes gain or loss measured by the difference between the amount received for his partnership interest or portion thereof and the basis of such interest or portion thereof. Since the whole of the basis of the member's partnership interest was allocable to his entire interest, two-thirds of his basis was allocable to two-third of his interest.

G. C. M. 26379, C. B. 1950-1, 58, holds that the sale of a partnership interest is a sale of a capital asset which is subject to the provisions of section 117 of the Internal Revenue Code of 1939. The disposition of a partnership interest, even though it be by way of liquidation thereof, is a capital transaction. Any gain or loss realized upon partial or complete liquidation of a partnership interest is capital in nature. The assessment paid by a partner for a year in which he partially or completely retires should be treated in the same manner as assessments paid by him in years prior to his retirement, that is, as an addition to his basis in his partnership interest, provided that the income tax is paid thereon.

Accordingly, it is held that goodwill units created by a partnership agreement constitute an integral and indivisible part of a partner's capital investment, and annual assessments paid by a partner to replenish the partnership capital based on his share of the firm's earnings are capital contributions which increase the basis of the partnership interest provided that the income tax is paid thereon. Any gain or loss realized upon the partial or complete liquidation of his partnership interest, a capital asset, is capital in nature and is measured by the difference between the amount received for the partnership interest or portion thereof and the basis of such interest or portion thereof.

Dividends paid on shares of stock sold and held in trust applied as payments against interest and principal of promissory note given for purchase of the stock. See Rev. Rul. 56-153, page 166.

SECTION 117 (c).—CAPITAL GAINS AND LOSSES: ALTERNATIVE TAXES

REGULATIONS 118, SECTION 39.117(c)-1: Alternative tax in case net long-term capital gain exceeds net short-term capital loss. Rev. Rul. 56-242

Public Law 399, 84th Congress, Second Session, 70 Stat. 8, page 853, this Bulletin, approved January 28, 1956, amended section 117(c)(1)(A) of the Internal Revenue Code of 1939, relating to alternative tax computation of corporations, to provide that in the computation of the credits for intercorporate dividends received, for dividends paid on certain preferred stock, and for Western Hemisphere trade corporations, a corporation's net income under the 1939 Code is to be determined without reduction for the excess of the net long-term capital gain over the net short-term capital loss. The amendment was made applicable with respect to taxable years beginning after December 31, 1951, and before January 1, 1954. See Revenue Ruling 56-151, page 382, this Bulletin, for corresponding provision with respect to alternative tax of corporations for taxable years subject to the Internal Revenue Code of 1954.

Prior to the enactment of Public Law 399, *supra*, Revenue Ruling 54-28, C. B. 1954-1, 123, held that in computing the alternative tax of corporations under the 1939 Code, the foregoing credits were to be determined upon the basis of the net income reduced by the excess of the net long-term capital gain over the net short-term capital loss. The provisions of Revenue Ruling 54-28, *supra*, were made applicable for the taxable year ended December 31, 1952, and subsequent taxable years by Revenue Ruling 54-283, C. B. 1954-2, 177. The committee report on Public Law 399, H. R. Report No. 1356, 84th Congress, page 853, this Bulletin, stated that the position in Revenue Ruling 54-28 should be reversed for years prior to 1954 in order to provide a consistent policy for the period of the 1939 Code.

In view of the provisions of Public Law 399, *supra*, Revenue Rulings 54-28 and 54-283, *supra*, are hereby revoked.

Computation of alternative tax where statutory deductions and/or credits exceed ordinary income (as distinguished from taxable capital gain). See Rev. Rul. 56-247, page 383.

SECTION 117(f).—CAPITAL GAINS AND LOSSES: RETIREMENT OF BONDS, ETC.

Proceeds of face-amount certificates issued prior to January 1, 1955, paid in installments. See Rev. Rul. 56-77, page 620.

Excess of the amount received over the price paid upon retirement of bonds. See Rev. Rul. 56-299, page 603.

SECTION 117(j).—CAPITAL GAINS AND LOSSES: GAINS AND LOSSES FROM INVOLUNTARY CONVERSION AND FROM THE SALE OR EXCHANGE OF CERTAIN PROPERTY USED IN THE TRADE OR BUSINESS

REGULATIONS 118, SECTION 39.117(j)-1: Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business.
(Also Section 112(b), Section 39.112(b)(7)-1.)

Rev. Rul. 56-160

Section 117(m) of the Internal Revenue Code of 1939 has no application to gain realized in 1953 by a corporation's former stockholders from the ultimate sale of real estate received in a liquidation under section 112(b)(7) of the Code. The gain realized on the sale is subject to the provisions of section 117(j) of the Code.

Advice has been requested whether the provisions of section 117(m) of the Internal Revenue Code of 1939 are applicable to the gain realized on a sale of certain property received in a corporate liquidation under section 112(b)(7) of the Code.

On October 15, 1952, a corporation was liquidated and gain was reported by the stockholders in accordance with the provisions of section 112(b)(7) of the Code. The three stockholders each of whom owned ten shares of the outstanding thirty shares of stock in the corporation, received all of the assets of the corporation in exchange for their stock. Among the assets distributed were land and a building constructed thereon by the corporation in 1950, which the corporation had leased to various tenants. On April 30, 1953, the former stockholders sold the land and building, which constituted section 117(j) property in their hands, at a gain of $180x$ dollars.

Section 112(b)(7) of the Code governs the recognition of the amount and type of gain in a corporate liquidation. Section 117(m) of the Code converts any recognized long-term capital gain arising from the liquidation of a collapsible corporation into ordinary income. Since a corporate liquidation under section 112(b)(7) of the Code constitutes, in general, a complete and closed transaction, the instant corporation, which might have been considered a collapsible corporation under section 117(m), went out of existence. Section 117(m) has no application to a transaction completely independent of a corporation, since the provisions of that section apply only to a gain from the sale or exchange of stock of a collapsible corporation or to a gain from a distribution made by such corporation to its stockholders.

Accordingly, it is held that section 117(m) of the Code has no application to a gain realized in 1953 by the corporation's former stockholders from the ultimate sale of real estate received in a liquidation under section 112(b)(7) of the Code. The gain realized on the sale is subject to the provisions of section 117(j) of the Code.

SECTION 117(m).—CAPITAL GAINS AND LOSSES: COLLAPSIBLE CORPORATIONS

REGULATIONS 118, SECTION 39.117(m)-1: Collapsible corporations.

Whether certain corporations, owned by United States citizens, but organized and operated in a foreign country constitute collapsible corporations. See Rev. Rul. 56–104, page 178.

SECTION 122.—NET OPERATING LOSS DEDUCTION

REGULATIONS 118, SECTION 39.122–2: Computation of net operating loss in case of a corporation. Rev. Rul. 56–161

(Also Section 125(a), Section 39.125(a)-1.)

> In determining a net operating loss under section 122 of the Internal Revenue Code of 1939, the amount of tax-exempt interest required to be added to statutory gross income under subsection (d)(2) of that section is the difference between the gross amount of interest received from wholly tax-exempt bonds and the amount of interest paid on indebtedness incurred or continued to purchase or carry tax-exempt bonds, without any reduction on account of amortizable bond premium on such bonds.

Advice has been requested whether, in determining a net operating loss under section 122 of the Internal Revenue Code of 1939, the tax-exempt interest to be included in the adjustments required by section 122(d)(2) is the gross amount of such interest, or whether it is the net amount of such interest after deducting amortizable bond premium on such bonds under section 125 of the Code.

Section 122(d)(2) of the Code provides that, in determining a net operating loss, there shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by chapter 1 of the Code, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23(b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations. Section 125(a)(2) of the Code provides that 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. As stated in section 39.125(a)-1(b)(1) of Regulations 118, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds.

Accordingly, it is held that, in determining a net operating loss under section 122 of the Code, the amount of tax-exempt interest required to be added to statutory gross income under subsection (d)(2) is the difference between the gross amount of interest received from wholly tax-exempt bonds and the amount of interest paid on indebtedness incurred or continued to purchase or carry tax-exempt bonds, without any reduction on account of amortizable bond premium on such bonds.

REGULATIONS 118, SECTION 39.122-4: Computation of net operating loss carryovers and net operating loss carryback.

Adjustment for excessive depreciation taken for the taxable year in which a net operating loss originated. See Rev. Rul. 56-285, page 134.

SECTION 125(a).—AMORTIZABLE BOND PREMIUM: GENERAL RULE

REGULATIONS 118, SECTION 39.125(a)-1: In general.

Amortizable premium on wholly tax-exempt bonds in the case of net operating loss adjustment for nontaxable interest under section 122(d)(2) of the Internal Revenue Code of 1939. See Rev. Rul. 56-161, page 634.

SECTION 127(c).—WAR LOSSES: RECOVERIES

REGULATIONS 118, SECTION 39.127(c)-1: Recoveries in respect of war losses. T. D. 6163 [1]
(Also Regulations 111, Section 29.127(c)-1.)

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 39.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1951

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 29.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1941

Regulations 118 and 111 amended with respect to interest on deficiencies and refunds resulting from recoveries of war losses.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Regulations 118 (26 CFR (1939) part 39) and Regulations 111 (26 CFR (1939) part 29) are amended as follows:

REGULATIONS 118

PARAGRAPH 1. Section 39.127(c)-1(d) as amended by Treasury Decision 6106, approved October 6, 1954 [C. B. 1954-2, 137] is amended by—

(A) Deleting the last sentence of subparagraph (3);
(B) Deleting the last sentence of subparagraph (4); and
(C) Adding a new subparagraph (5) as follows:

(5) In the case of any taxable year ending before the date of the making by the taxpayer of an election under section 127(c)(5), no interest shall be paid on any overpayment specified in subparagraph (4) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer, and no interest shall be assessed or collected with respect to any amount or any deficiency specified in subparagraph (3) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer.

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[1] 21 F. R. 1639.

REGULATIONS 111

PAR. 2. Section 29.127(c)-1(d), as amended by Treasury Decision 5968, approved December 29, 1952 [C. B. 1953-1, 206] is amended by—

(A) Deleting the last sentence of subparagraph (3);
(B) Deleting the last sentence of subparagraph (4); and
(C) Adding a new subparagraph (5) as follows:

(5) In the case of any taxable year ending before the date of the making by the taxpayer of an election under section 127(c)(5), no interest shall be paid on any overpayment specified in subparagraph (4) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer, and no interest shall be assessed or collected with respect to any amount or any deficiency specified in subparagraph (3) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer.

Because this Treasury Decision liberalizes the present provisions of Regulations 118 and 111 relative to interest on certain refunds, it is found unnecessary to issue this Treasury Decision with notice and public procedure thereon under section 4(a) of the Administrative Procedure Act, approved June 11, 1946, or subject to the effective date limitation of section 4(c) of said Act.

(This Treasury Decision is issued under the authority contained in sections 62 and 3791 of the Internal Revenue Code of 1939 (53 Stat. 32, 467; 26 U. S. C. 62, 3791) and in section 127(c) of the Internal Revenue Code of 1939 (65 Stat. 511; 26 U. S. C. 127(c)).)

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved March 8, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Filed by the Division of the Federal Register, March 14, 1956; 8:45 a. m.)

REGULATIONS 111, SECTION 29.127(c)-1: Recoveries in respect of war losses.

Regulations 111 amended. See T. D. 6163, above.

SECTION 130.—LIMITATION ON DEDUCTIONS ALLOWABLE TO INDIVIDUALS IN CERTAIN CASES

REGULATIONS 118, SECTION 39.130-1: Limitation on deductions allowable to individuals in certain cases. Rev. Rul. 56-191

Capital gains must be included in full in gross income in determining whether, under section 130 of the Internal Revenue Code of 1939, the deductions attributable to a trade or business carried on by an individual for five consecutive taxable years have, in each of such years, exceeded by more than $50,000 the gross income derived from such trade or business.

Revenue Ruling 219, C. B. 1953-2, 181, modified.

Reconsideration has been given to Revenue Ruling 219, C. B. 1953–2, 181, in view of the recent decision of the Tax Court of the United States in *James M. McDonald* v. *Commissioner*, 23 T. C. 1052, acquiescence, page 6, this Bulletin.

Revenue Ruling 219 holds, in part, that, for the purpose of section 130 of the Internal Revenue Code of 1939 and for taxable years prior to those to which the Revenue Act of 1951 applies, only one-half of long-term capital gains are includible in gross income, citing *United States* v. *Helen W. Benedict* et al., 338 U. S. 692, Ct. D. 1730, C. B. 1950–1, 70.

Section 130 of the Internal Revenue Code of 1939 provides, in part, as follows:

> If the deductions (other than taxes and interest) allowable to an individual (except for the provisions of this section) and attributable to a trade or business carried on by him or five consecutive taxable years have, in each of such years, exceeded by more than $50,000 the gross income derived from such trade or business, the net income 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.

In the Benedict case, the court was concerned with the application of section 162(a) of the Internal Revenue Code of 1939, relating to the allowance of certain deductions in computing the net income of a trust. The holding in that case, that only one-half of long term capital gains are includible in gross income, was based upon the conclusion that such treatment best effectuated the Congressional intent underlying the enactment of section 162 of the Code.

In the McDonald case the taxpayer, owner of a dairy and breeding herd, sustained a loss on his operations during each of the years 1942 to 1946, inclusive. In 1946 the taxpayer sold certain cattle from his herd, realizing long-term capital gains upon such sale. Only 50 percent of such capital gains were included by the Commissioner in the gross income of the taxpayer for that year. On such basis, his deductions for 1946, as determined under section 130 of the Code, exceeded by more than $50,000 the gross income from his business. For each of the four years prior to 1946, the taxpayer's deductions, similarly determined, also exceeded gross income by more than $50,000. The specific question presented was whether the chain of loss years was broken in 1946 so as to make inapplicable the provisions of section 130 of the Code. The court held that for the purpose of section 130 of the Code, 100 percent of the capital gains must be included in gross income. On such basis, the taxpayer's deduction for 1946 did not exceed his gross income for such year by more than $50,000 and, therefore, the chain of loss years was broken in 1946 and the taxpayer's net income was not subject to recomputation under such section.

In reaching such conclusion the court stated:

> We, therefore, hold that, for the purpose of a section 130 recomputation, gross income includes 100 percent of the capital gains realized by an individual. As in the Benedict case (which construed a different section of the Code), we follow the rationale there used by the Supreme Court and reach a conclusion that will best effectuate the congressional intent underlying the enactment of section 130;

and, while the result herein is different from the result in that case, we feel it is justified here, as it was there, in order to give proper effect to the purpose of the section.

In view of the above, it is held that capital gains must be included in full in gross income in determining whether, under section 130 of the Internal Revenue Code of 1939, the deductions attributable to a trade or business carried on by an individual for five consecutive taxable years have, in each of such years, exceeded by more than $50,000 the gross income derived from such trade or business.

Revenue Ruling 219, C. B. 1953–2, 181, is modified to accord with the foregoing.

SUPPLEMENT C.—CREDITS AGAINST TAX

SECTION 131(a).—TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF THE UNITED STATES: ALLOWANCE OF CREDIT

REGULATIONS 118, SECTION 39.131(a)–1: Analysis of credit for taxes.

Credit for taxes paid to Australia attributable to trust income from sources in Australia. See Rev. Rul. 56–30, page 646.

Limitation period for a taxpayer who elects to claim credit where net operating loss carryback is involved. See Rev. Rul. 56–196, page 655.

SUPPLEMENT D.—RETURNS AND PAYMENT OF TAX

SECTION 141.—CONSOLIDATED RETURNS

REGULATIONS 118, SECTION 39.141–1: Consolidated income and excess profits tax returns of affiliated corporations.

Consolidated return involving includible subsidiaries whose stock was less than 95 percent owned by a parent for years prior to January 1, 1954, but was more than 80 percent directly or indirectly owned for a part of the taxable year 1954. See Rev. Rul. 56–34, page 436.

SECTION 143.—WITHHOLDING OF TAX AT SOURCE

REGULATIONS 118, SECTION 39.143–9: Return of income from which tax was withheld.

Credit for taxes withheld from dividends on American securities in Australian trust. See Rev. Rul. 56–30, page 646.

SECTION 145.—PENALTIES

REGULATIONS 118, SECTION 39.145–1: Penalties. Ct. D. 1794

CRIMINAL LIABILITY—INTERNAL REVENUE CODE OF 1939—DECISION OF SUPREME COURT.

1. PENALTIES—CRIMINAL PROSECUTION—NET WORTH METHOD—INDICTMENT BY GRAND JURY BASED ON HEARSAY.

An indictment for wilful evasion of income taxes based solely on hearsay evidence of Government agents does not violate the Fifth Amendment, since neither the Fifth Amendment nor any other constitutional provision prescribes the kind of evidence upon which grand juries must act. An indictment returned by a legally constituted and unbiased grand jury, if valid on its face, is enough to call for trial of the charge on the merits. Further, there is no necessity for establishing a rule permitting defendants to challenge indictments on the ground that they are not supported by competent evidence.

2. JUDGMENT AFFIRMED.

Judgment of the United States Circuit Court of Appeals for the Second Circuit (221 F. 2d 668) affirmed.

SUPREME COURT OF THE UNITED STATES

Frank Costello, petitioner v. *United States of America*

On writ of certiorari to the United States Court of Appeals for the Second Circuit

[March 5, 1956]

OPINION

Mr. Justice Black delivered the opinion of the Court.

We granted certiorari in this case to consider a single question: "May a defendant be required to stand trial and a conviction be sustained where only hearsay evidence is presented to the grand jury which indicted him?" 350 U. S. 819.

Petitioner, Frank Costello, was indicted for wilfully attempting to evade payment of income taxes due the United States for the years 1947, 1948 and 1949.[1] The charge was that petitioner falsely and fraudulently reported less income than he and his wife actually received during the taxable years in question. Petitioner promptly filed a motion for inspection of the minutes of the grand jury and for a dismissal of the indictment. His motion was based on an affidavit stating that he was firmly convinced there could have been no legal or competent evidence before the grand jury which indicted him since he had reported all his income and paid all taxes due. The motion was denied. At the trial which followed the Government offered evidence designed to show increases in Costello's net worth in an attempt to prove that he had received more income during the years in question than he had reported.[2] To establish its case the Government called and examined 144 witnesses and introduced 368 exhibits. All of the testimony and documents related to business transactions and expenditures by petitioner and his wife. The prosecution concluded its case by calling three Government agents. Their investigations had produced the evidence used against petitioner at the trial. They were allowed to summarize the vast amount of evidence already heard and to introduce computations showing, if correct, that petitioner and his wife had received far greater income than they had reported. We have held such summarizations admissible in a "net worth" case like this. *United States* v. *Johnson*, 319 U. S. 503 [Ct. D. 1587, C. B. 1943, 995].

Counsel for petitioner asked each Government witness at the trial whether he had appeared before the grand jury which returned the indictment. This cross-

[1] The indictment was based on section 145(b) of the Internal Revenue Code of 1939. 53 Stat. 63. There was also a count in the indictment for the year 1946 but petitioner was found not guilty of this charge.

[2] For discussions of the "net worth method," see *Holland* v. *United States*, 348 U. S. 121 [Ct. D. 1769, C. B. 1954–2, 215]; *Friedberg* v. *United States*, 348 U. S. 142 [Ct. D. 1770, C. B. 1954–2, 29]; *Smith* v. *United States*, 348 U. S. 147 [Ct. D. 1771, C. B. 1954–2, 225]; and *United States* v. *Calderon*, 348 U. S. 160 [Ct. D. 1772, C. B. 1954–2, 36].

examination developed the fact that the three investigating officers had been the only witnesses before the grand jury. After the Government concluded its case, petitioner again moved to dismiss the indictment on the ground that the only evidence before the grand jury was "hearsay," since the three officers had no first-hand knowledge of the transactions upon which their computations were based. Nevertheless the trial court again refused to dismiss the indictment, and petitioner was convicted. The Court of Appeals affirmed,[3] holding that the indictment was valid even though the sole evidence before the grand jury was hearsay.[4] Petitioner here urges: (1) that an indictment based solely on hearsay evidence violates that part of the Fifth Amendment providing that "No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury. . . ." and (2) that if the Fifth Amendment does not invalidate an indictment based solely on hearsay we should now lay down such a rule for the guidance of federal courts. See *McNabb* v. *United States*, 318 U. S. 332, 340–341.

The Fifth Amendment provides that Federal prosecutions for capital or otherwise infamous crimes must be instituted by presentments or indictments of grand juries. But neither the Fifth Amendment nor any other constitutional provision prescribes the kind of evidence upon which grand juries must act. The grand jury is an English institution, brought to this country by the early colonists and incorporated in the Constitution by the Founders. There is every reason to believe that our constitutional grand jury was intended to operate substantially like its English progenitor. The basic purpose of the English grand jury was to provide a fair method for instituting criminal proceedings against persons believed to have committed crimes. Grand jurors were selected from the body of the people and their work was not hampered by rigid procedural or evidential rules. In fact, grand jurors could act on their own knowledge and were free to make their presentments or indictments on such information as they deemed satisfactory. Despite its broad power to institute criminal proceedings the grand jury grew in popular favor with the years. It acquired an independence in England free from control by the Crown or judges. Its adoption in our Constitution as the sole method for preferring charges in serious criminal cases shows the high place it held as an instrument of justice. And in this country as in England of old the grand jury has convened as a body of laymen, free from technical rules, acting in secret, pledged to indict no one because of prejudice and to free no one because of special favor. As late as 1927 an English historian could say that English grand juries were still free to act on their own knowledge if they pleased to do so.[5] And in 1852 Mr. Justice Nelson on circuit could say "No case has been cited, nor have we been able to find any, furnishing an authority for looking into and revising the judgment of the grand jury upon the evidence, for the purpose of determining whether or not the finding was founded upon sufficient proof. . . ." *United States* v. *Reed*, 27 Fed. Cas. 727, 738.[6]

In *Holt* v. *United States*, 218 U. S. 245, this Court had to decide whether an indictment should be quashed because supported in part by incompetent evidence. Aside from the incompetent evidence "there was very little evidence against the accused." The Court refused to hold that such an indictment should be quashed, pointing out that "The abuses of criminal practice would be enhanced if indictments could be upset on such a ground." 218 U. S., at 248. The same thing is true where as here all the evidence before the grand jury was in the nature of "hearsay." If indictments were to be held open to challenge on the ground that there was inadequate or incompetent evidence before the grand jury, the resulting delay would be great indeed. The result of such a rule would be that before trial

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[3] 221 F. 2d 668. The Court of Appeals reversed petitioner's conviction on the 1947 count on grounds not material here.

[4] Varying views have been expressed concerning whether indictments may be challenged because based in whole or in part on incompetent evidence. See, *e. g.*, *Chadwick* v. *United States*, 141 F. 225; *United States* v. *Violin*, 173 F. 501; *Nanfito* v. *United States*, 20 F. 2d 376, 378; *Brady* v. *United States*, 24 F. 2d 405; *Banks* v. *United States*, 204 F. 2d 666; *Zacher* v. *United States*, 227 F. 2d 219. See also cases collected in 62 Harv. L. Rev. 111; 38 Yale L. J. 680; 71 Cent. L. J. 9; Joyce, Indictments (2d ed., Blakemore, 1924), 166–168; Note, 24 A. L. R. 1432.

[5] 1 Holdsworth, History of English Law, 323.

[6] As to the development of the grand jury as an institution here and in England, see *Hale* v. *Henkel*, 201 U. S. 43, 59; *Blair* v. *United States*, 250 U. S. 273, 282; *McGrain* v. *Daugherty*, 273 U. S. 135, 157; *United States* v. *Johnson*, 319 U. S. 503 [Ct. D. 1587, C. B. 1943, 995]; 4 Blackstone Commentaries 301 *et seq.*; 1 Pollock and Maitland, History of English Law (1895), 130; 1 Holdsworth, History of English Law, 312–323; Morse, A Survey of the Grand Jury System, 10 Ore. L. Rev. 101, 217, 295.

on the merits a defendant could always insist on a kind of preliminary trial to determine the competency and adequacy of the evidence before the grand jury. This is not required by the Fifth Amendment. An indictment returned by a legally constituted and unbiased grand jury,[7] like an information drawn by the prosecutor, if valid on its face, is enough to call for trial of the charge on the merits. The Fifth Amendment requires nothing more.

Petitioner urges that this Court should exercise its power to supervise the administration of justice in Federal courts and establish a rule permitting defendants to challenge indictments on the ground that they are not supported by adequate or competent evidence. No persuasive reasons are advanced for establishing such a rule. It would run counter to the whole history of the grand jury institution, in which laymen conduct their inquiries unfettered by technical rules. Neither justice nor the concept of a fair trial requires such a change. In a trial on the merits, defendants are entitled to a strict observance of all the rules designed to bring about a fair verdict. Defendants are not entitled, however, to a rule which would result in interminable delay but add nothing to the assurance of a fair trial.

Affirmed.

Mr. Justice Clark and Mr. Justice Harlan took no part in the consideration or decision of this case.

Mr. Justice Burton concurring in a separate opinion.

Ct. D. 1795

CRIMINAL LAW AND PROCEDURE—INTERNAL REVENUE CODE OF 1939—DECISION OF SUPREME COURT.

1. CONTACT WITH JUROR—CONSTRUCTION OF MANDATE.

During the trial of the taxpayer on tax evasion charges, an acquaintance of one of the jurors, who professed to know the taxpayer well, approached the juror with a suggestion that he make a deal with the taxpayer. The juror reported the matter to the trial judge; the judge related the incident to the District Attorney, and the matter was referred to the F. B. I. The defense was not advised of the incident. An agent of the F. B. I. called on the juror and explained that he was conducting an investigation of the matter and the possibility of an improper approach by the outsider. The juror never knew during the remainder of the trial what the outcome of the investigation was and it was not until after the trial, which resulted in a verdict of guilty, that the F. B. I. determined further investigation was unwarranted. On remand of the case by the Supreme Court to the District Court with directions to hold a hearing to determine whether the foregoing events were prejudicial to the taxpayer, the District Court construed the mandate to mean an inquiry into the purpose and effect of the F. B. I. investigation. The District Court found that the purpose of the F. B. I. investigation was not to examine the juror's conduct but to determine whether the outsider had committed an offense. On that basis the District Court held that the incident was no prejudicial to the taxpayer. The Supreme Court held that the District Court's construction of its mandate was unduly restrictive and had the effect of diluting the force of all the factors that may have influenced and disturbed the juror in the free exercise of his judgment. After consideration of the evidence in the record the Supreme Court found that the juror had been subject to extraneous influences to which no juror should be subjected and that the taxpayer was entitled to a new trial.

2. JUDGMENT VACATED.

Jurgment of the United States Court of Appeals for the Ninth Circuit (222 F. (2d) 720) vacated and case remanded.

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[7] See, *e. g.*, *Pierre* v. *Louisiana*, 306 U. S. 354.

SUPREME COURT OF THE UNITED STATES

Elmer F. Remmer, petitioner, v. *United States of America*

On writ of certiorari to the United States Court of Appeals for the Ninth Circuit

[March 5, 1956]

OPINION

Mr. Justice Minton delivered the opinion of the Court.

The case is here for the third time. Petitioner was convicted on four counts of willfully attempting to evade and defeat Federal income taxes. When this case was first here we knew nothing about the facts concerning the phase of the case now before us. It was alleged in the petitioner's motion and affidavits supporting his motion for a new trial that during the trial one juror, Smith, had been approached by one Satterly, an outsider, with a suggestion that the juror could make some easy money if he would make a deal with petitioner Remmer. It was further alleged by the petitioner that the juror reported the matter to the trial judge, who in turn reported it to the district attorney, who, with the judge's approval called in the Federal Bureau of Investigation—all of which was unknown to the petitioner until he read about it in the newspaper after the jury had returned its verdict finding him guilty. The Government did not deny these allegations. We sent the case back to the District Court with directions to hold a hearing, with the petitioner and counsel present, to determine from the facts whether or not communication with the juror by the outsider and the events that followed were prejudicial and, therefore, harmful to the petitioner, and, if so, to grant a new trial. 347 U. S. 227. On remand, the District Court held a hearing and found the incidents to be free of harm. 122 S. Supp. 673. Thereafter, this Court remanded the entire record to the Court of Appeals for the Ninth Circuit to consider the whole case in the light of our recent net worth decisions. 348 U. S. 904. The Court of Appeals reviewed the whole record and affirmed the petitioner's conviction in a per curiam opinion. 222 F. 2d 720.

The case is here again on certiorari, limited to the question of the effect of the extraneous communications with the juror upon the petitioner's right to a fair trial. 350 U. S. 820. The District Court read our opinion and mandate to mean that "the incident complained of" to be inquired into at the hearing was the purpose and effect of the F. B. I. investigation. The District Court found that the purpose of the F. B. I. investigation was not to examine Smith's conduct, but rather to determine whether Satterly had committed an offense. The court further found that the F. B. I. agent's discussion with Smith had "no effect whatever upon the judgment or the integrity or state of mind" of Smith, whom the court found to be a "forthright and honest man." On the basis of these two findings, the court concluded:

> "Consequently, the court finds that 'the incident complained of' was entirely harmless so far as the petitioner was concerned and did not have the slightest bearing upon the integrity of the verdict nor the state of mind of the foreman of the jury, or any of the members of the jury. Thus any presumption of prejudice is conclusively dispelled. . . ."

The District Court's limit of our mandate, it seems to us, is hardly warranted by the language of the opinion, even though the language might well have been more explicit. It was our intention that the entire picture should be explored and the incident complained of and to be examined included Satterly's communication with the juror and the impact thereof upon him then, immediately thereafter, and during the trial, taken together with the fact that the F. B. I. was investigating a circumstance involving the juror and the fact that the juror never knew all during the balance of the trial what the outcome of that investigation was. Thus we stated: "In a criminal case, any private communication, contact, or tampering, directly or indirectly with a juror during a trial about the matter pending before the jury is, for obvious reasons, deemed presumptively prejudicial if not made in pursuance of known rules of the court . . . with full knowledge of the parties." 347 U. S., at 288. We also pointed out that the record we had before us did not reflect what in fact transpired, "or whether the incidents that may have occurred were harmful or harmless." *Ibid.* It was the paucity of information relating to the entire situation coupled with the presumption which attaches to the kind of facts alleged by petitioner which, in our view, made manifest the need for a full hearing. Never-

theless, there is sufficient evidence in the record relating to the total situation, including both the Satterly and the F. B. I. contacts, which makes it unnecessary to remand the case for further consideration. We will consider the evidence free from what we think are the unduly narrow limits of the question as viewed by the District Court.

The evidence shows that three weeks after the trial started, juror Smith, who is a real estate and insurance broker, was visited in his home by Satterly and his wife about an insurance policy. Satterly had been employed in a gambling house in Nevada as a dealer of craps. The petitioner was or had been engaged in the operation of gambling houses in Nevada. The Satterlys had met the Smiths socially at a hunting lodge. Smith and Satterly seated themselves in one end of a large room and their wives were seated in the other end of the room, a convenient arrangement if an approach was to be made. Smith testified that Satterly said to him: "I know Bones Remmer very well. He sold Cal-Neva for $850,000 and really got about $300,000 under the table which he daresn't touch. Why don't you make a deal with him?" Smith vigorously reminded Satterly that he was on the jury and that he could not talk about the case. Nothing more was said. Smith was disturbed. As he later testified, "I always felt, whether Satterly said it in so many words or not, I always felt that money was involved; otherwise why would any question be put to me." So disturbed was Smith that he told the trial judge about it. The judge's reaction, at least as he manifested it to Smith, was that the Satterly conversation should be regarded as a joke. But the judge related the incident to the district attorney and they decided to refer the matter to the Federal Bureau of Investigation. Shortly thereafter, during a recess, an F. B. I. agent called on Smith at his place of business. Smith testified that the agent explained the purpose of this visit as follows: "He told me that he had been instructed to come and interview me relative to this conversation I had with Satterly. To check and see if there was anything to this or not." On direct examination the agent testified: "I told him I had been requested to conduct an investigation relating to his talk with Mr. Satterly and the possibility of an improper approach." In reply to questions put by the District Court, the agent testified that he had explained to Smith that the purpose of his investigation was to examine Satterly's conduct. Satterly was never interviewed by the F. B. I. during its investigation. It was not until a month after the trial had ended that the Government determined that further investigation or criminal prosecution was unwarranted.

Driving home after the trial with two other jurors, Smith mentioned that there was some question as to whether he had been approached during the trial and that he had reported the incident to the trial judge. He thanked one of the jurors on dropping her at her home, "because I have been under teriffic pressure . . . . sometime I will discuss it."

We think this evidence, covering the total picture, reveals such a state of facts that Mr. Smith or no one else could say that he was not affected in his freedom of action as a juror. From Smith's testimony it is quite evident that he was a disturbed and troubled man from the date of the Satterly contact until after the trial. Proper concern for protecting and preserving the integrity of our jury system dictates against our speculating that the F. B. I. agent's interview with Smith, whatever the Government may have understood its purpose to be, dispersed the cloud created by Satterly's communication. As he sat on the jury for the remainder of the long trial and as he cast his ballot, Smith was never aware of the Government's interpretation of the events to which he, however unwillingly, had become a party. He had been subjected to extraneous influences to which no juror should be subjected, for it is the law's objective to guard jealously the sanctity of the jury's right to operate as freely as possible from outside unauthorized intrusions purposefully made.

The unduly restrictive interpretation of the question by the District Court had the effect of diluting the force of all the other facts and circumstances in the case that may have influenced and disturbed Smith in the untrammeled exercise of his judgment as a juror. We hold that on a consideration of all the evidence uninfluenced by the District Court's narrow construction of the incident complained of, petitioner is entitled to a new trial.

The Court of Appeals' judgment is vacated and the case is remanded to the District Court with directions to grant a new trial.

It is so ordered.

Mr. Chief Justice Warren and Mr. Justice Harlan took no part in the consideration or decision of this case.

(Also Section 3616.) Ct. D. 1797

CRIMINAL LIABILITY AND PROCEDURE—INTERNAL REVENUE CODE OF 1939—DECISION OF SUPREME COURT

1. TAX EVASION—FILING FALSE RETURN, CONDUCT INCLUDED IN BOTH FELONY AND MISDEMEANOR STATUTES—REQUESTED INSTRUCTIONS TO JURY

In a criminal prosecution for willful attempt to evade and defeat income tax, where the facts necessary to prove a Section 145(b) violation (Code of 1939) were identical with those required to prove the misdemeanor defined in Section 3616(a), defendant is not entitled to a jury instruction that he could be found guilty of the misdemeanor. Where the facts necessary to prove one crime are identical with those required to prove another, the function of the jury is to decide only the issues of fact and determine guilt or innocence, taking the law as given by the Court. The jury does not determine punishment.

2. JUDGMENT AFFIRMED.

Judgment of the United States Court of Appeals for the Eighth Circuit, 221 F. 2d 590, affirmed.

SUPREME COURT OF THE UNITED STATES

Louis Berra, petitioner, v. *United States of America*

On writ of certiorari to the United States Court of Appeals for the Eighth Circuit

[April 30, 1956]

OPINION

Mr. Justice Harlan delivered the opinion of the Court.

Petitioner was charged, in a three-count indictment, with wilfully attempting to evade federal income taxes for 1951, 1952, and 1953 by filing with the Collector "false and fraudulent" tax returns, "in violation of section 145(b), title 26, United States Code."[1] That section of the Internal Revenue Code of 1939, 53 Stat, 63, provided:

> "Any person * * * who willfully attempts in any manner to evade or defeat any tax imposed by this chapter or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than five years, or both, together with the costs of prosecution."

Section 3616(a) of the 1939 Code, 53 Stat. 440, also made it a crime for any person to deliver to the Collector "any false or fraudulent list, return, account, or statement, with intent to defeat or evade the valuation, enumeration, or assessment intended to be made * * *." The penalty for violation of section 3616(a), however, was a fine of not more than $1,000, or imprisonment not exceeding one year, or both, together with the costs of prosecution.

At the close of the trial judge's charge to the jury, petitioner asked that the jury be instructed with respect to each count that a verdict of guilty of the "lesser crime" under section 3616(a) would be permissible.[2] No motions addressed to the validity of the indictment, judgment of conviction, or sentence under section 145(b) were made before, during, or after trial, and we read the requested instruction as aimed at leaving to the jury the question of whether the

[1] This case arises under the Internal Revenue Code of 1939. The sections involved have been changed in the 1954 Code; see sections 7201, 7207.

[2] "Defendant's Requested Instruction No. 12.

"Under the law you may find the defendant guilty of a lesser crime than the crime charged in each count of the income tax indictment.

"The statute upon which the lesser crime is based, omitting that part of the act which does not apply in this case, reads as follows:

"Whenever any person * * * delivers or discloses to a collector * * * any false or fraudulent * * * return * * * with intent to defeat or evade the * * * assessment intended to be made, shall be guilty of a misdemeanor.

"Under Count I if you find and believe from the evidence that the defendant delivered, caused to be delivered or disclosed to the Collector of Internal Revenue for the First Collection District of Missouri, a false income tax return with intent to defeat or evade the assessment intended to be made, you will find him guilty of this lesser crime." (This paragraph was repeated for Counts II and III.)

defendant should be convicted under section 145(b) or section 3616(a), if the jury found him guilty. The instruction was refused, and, after conviction, petitioner was sentenced to four years' imprisonment on each count, the sentences to run concurrently. Thus petitioner has been sentenced to imprisonment greater than the maximum possible had the conviction been under section 3616(a) alone. The Court of Appeals affirmed, 221 F. 2d 590, and we granted certiorari, 350 U. S. 910, limited to the question of whether it was error for the trial judge to refuse to give the requested instruction.

The Court of Appeals, in affirming the conviction, held that section 3616(a) did not apply to income tax returns, and that any instruction relating to that section would therefore have been irrelevant under the evidence in this case.[3] Both parties agree, however, that section 3616(a) *was* applicable to income tax returns, and we shall assume, *arguendo*, the correctness of that interpretation of the statute.

Rule 31(c) of the Federal Rules of Criminal Procedure provides that a defendant may be found guilty of an offense "necessarily included in the offense charged."[4] In a case where some of the elements of the crime charged themselves constitute a lesser crime, the defendant, if the evidence justified it, would no doubt be entitled to an instruction which would permit a finding of guilt of the lesser offense. See *Stevenson* v. *United States*, 162 U. S. 313. But this is not such a case. For here the method of evasion charged was the filing of a false return, and it is apparent that the facts necessary to prove that petitioner "willfully" attempted to evade taxes by filing a false return (section 145(b)) were identical with those required to prove that he delivered a false return with "intent" to evade taxes (section 3616(a)). In this instance sections 145(b) and 3616(a) covered precisely the same ground.[5]

Petitioner contends that he was nevertheless entitled to the requested instruction. He argues that since there was no difference in the proof required to establish violations of sections 145(b) and 3616(a), the indictment must be taken as charging violations of both sections, and in the jury under Rule 31(c) should have been permitted to make the choice between the two crimes. We do not agree.

The role of the jury in a federal criminal case is to decide only the issues of fact, taking the law as given by the Court. *Sparf* v. *United States*, 156 U. S. 51, 102. Certainly Rule 31(c) was never intended to change this traditional function of the jury.[6] Here, whether section 145(b) or section 3616(a) be deemed to govern, the factual issues to be submitted to the jury were the same; the instruction requested by petitioner would not have added any other such issue for the jury's determination.[7] When the jury resolved those issues against petitioner, its function was exhausted, since there is here no statutory provision giving to the jury the right to determine the punishment to be imposed after the determination of guilt.[8] Whatever other questions might have been raised as to the validity of petitioner's conviction and sentence, because of the assumed overlapping of sections 145(b) and 3616(a), were questions of law for the court. No such questions are presented here.

The only question before us is whether the jury should have been allowed to decide whether it would apply section 3616(a) rather than section 145(b), and that we hold was not for the jury. It was, therefore, not error to refuse the requested instruction.

Affirmed.

Mr. Justice Black, joined by Mr. Justice Douglas, dissenting in a separate opinion.

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[3] In so holding the Court of Appeals followed its earlier decision in *Dillon* v. *United States*, 218 F. 2d 97.

[4] "Rule 31. VERDICT * * * (c) *Conviction of Less Offense.*—The defendant may be found guilty of an offense necessarily included in the offense charged or of an attempt to commit either the offense charged or an offense necessarily included therein if the attempt is an offense."

[5] Compare section 7207 of the Internal Revenue Code of 1954, under which the wilful filing of a false return no longer requires the element of an "intent to defeat or evade" taxes, as was so under the former section 3616(a).

[6] The notes of the Advisory Committee state that Rule 31(c) "is a restatement of existing law." The preceding "lesser offense" statutes were Act of June 1, 1872, 17 Stat. 196; R. S. section 1035; 18 U. S. C. section 565. Cf. *Stevenson* v. *United States*, *supra*, at pages 315, 322, 323; *Sparf* v. *United States*, *supra*, at page 103; *Ekberg* v. *United States*, 167 F. 2d 380, 385.

[7] Indeed, had there been any separate factual issues under section 3616(a), it is plain that the requested instruction would have been inadequate to raise them for the jury.

[8] Cf. *Andres* v. *United States*, 333 U. S. 740.

SECTION 162.—NET INCOME

REGULATIONS 118, SECTION 39.162-1: Income of estates and trusts. (Also Sections 131(a), 143; Sections 39.131(a)-1, 39.143-9.) — Rev. Rul. 56-30

Treatment for Federal income tax purposes of income received by a citizen and resident of the United States who is the beneficiary of a trust created in a foreign country the assets of which are composed of Australian investments and American securities.

Advice has been requested relative to the treatment of income received by a citizen and resident of the United States under the circumstances set forth below.

The trustees of an Australian trust are given the power in their sole and unfettered discretion to pay the income therefrom to the beneficiary, a citizen and resident of the United States. The assets of the trust are composed of Australian investments and American securities. The beneficiary was taxed in Australia on the whole of the income earned on Australian investments although the full amount of income was not paid to him. Since he was a resident of the United States, Australia did not assess a tax on the dividends received on the American stock owned by the trust. The tax on these dividends was deducted at the source and the net amount only was paid to the credit of the trustees and in turn to the beneficiary.

Where the discretionary powers given to the trustee include, expressly or by implication, the right to decide whether to pay or withhold and accumulate the amount which he determines is income, the trust is a discretionary trust.

The rules for determining the net income of the beneficiaries of a distributable trust are given in section 162(b) of the Internal Revenue Code of 1939. The trust is permitted to deduct the amount which is to be currently distributed under the same provision. In contrast, the discretionary trust is permitted to deduct only that portion of the trust income which is properly paid or credited to the beneficiaries within their taxable year. The rules for determining the net income of the beneficiaries of a discretionary trust are given in section 162(c) of the Internal Revenue Code of 1939.

The Commonwealth of Australia Income Tax Assessment Act, 1936–1939, provides in part in Division 6 as follows:

101. For the purposes of this Division, where a trustee has a discretion to pay or apply income of a trust estate to or for the benefit of specified beneficiaries, a beneficiary in whose favour the trustee exercises his discretion shall be deemed to be presently entitled to the amount paid to him or applied for his benefit by the trustee in the exercise of this discretion.

In view of the foregoing, the beneficiary should report on his Federal income tax return only the amount which equals the sum of the payments actually or constructively made by the trustees of the Australian trust to or for his benefit. He will not be liable for Federal income tax on income withheld by the trustees and added to the corpus of the trust.

When income is received by a trust from several sources and only a part of such income is properly distributable to a beneficiary, the income of the beneficiary is considered to have been received proportionately from the several sources. See *J. Cornelius Rathborne* v. *Commissioner*, 37 B. T. A. 607, affirmed 103 Fed. (2d) 301.

If the standard deduction is not claimed on the return, and if the income taxes paid to Australia are not deducted from adjusted gross income, the beneficiary is entitled to credit against his United States income tax, under the conditions and with the limitations prescribed in section 131 of the Internal Revenue Code of 1939, the income taxes paid or accrued to Australia during the taxable year which are attributable to the trust income reported by him from sources within Australia. See *American Chicle Co.* v. *United States*, 316 U. S. 450, Ct. D. 1561, C. B. 1942–1, 161.

Section 39.143–9(b) of Regulations 118 provides that the tax withheld at the source upon fixed or determinable annual or periodical income paid to nonresident alien fiduciaries is deemed to have been paid by the persons ultimately liable for the tax upon such income. Accordingly, if an individual is subject to the taxes imposed by sections 11 and 12 of the Internal Revenue Code of 1939 upon any portion of the income of a foreign trust, the part of the tax withheld at the source from income of the trust which is allocable to the income so taxed to such individual shall be credited against the amount of the income tax computed upon his return. Any excess shall be credited against the income tax then due from the taxpayer and any balance shall be refunded.

In view of the foregoing, the gross amount of dividends received on American securities properly distributable by the trust to the beneficiary should be included in his gross income without the deduction of any amount for tax withheld at the source from such dividends when the dividends were paid to the trust. He may then credit the tax withheld at the source (under the provisions of section 143(d) of the 1939 Code) which is attributable to such dividends reported in his United States income tax return.

The following example illustrates the treatment to be accorded income received by a beneficiary under similar conditions:

A trust created in foreign country *A* receives the following income during the course of a year:

Interest from foreign country *A*	$6,000
Dividends from foreign country *B*	3,000
Dividends from the United States	1,000
Total	$10,000

From this income, the trust distributes $8,000 to the beneficiary. Then 6,000/10,000×$8,000, or $4,800, is considered interest income from foreign country *A*; 3,000/10,000×$8,000, or $2,400, is considered dividend income from foreign country *B*; and 1,000/10,000×$8,000, or $800, is considered dividend income from the United States.

Assuming that foreign country *A* imposes a tax of $1,000 on the $6,000 income of the trust from within that foreign country, the tax attributable to income from foreign country *A* to be considered in com-

puting the credit against the beneficiary's United States income tax will amount to $800 computed as follows:

$$4,800/6,000 \times \$1,000 = \$800$$

But note the conditions and limitations on the foreign tax credit in section 131 of the 1939 Code.

Assuming further that the amount of tax withheld from dividends received by the trust from sources within the United States amounts to $300, the portion of tax withheld attributable to the beneficiary's income from sources within the United States will amount to $240, computed as follows:

$$800/1,000 \times \$300 = \$240.$$

Rev. Rul. 56–78

Ordinary income or capital gain realized by a liquidating trust created under the authority of Chapter 745 of the Laws of 1933, New York (known as the Schackno Act), currently distributed to a beneficiary, is includible in the gross income of the recipient for his taxable year in which or with which the taxable year of the trust ends. Capital gain realized by the trustee on sale of the trust property, which is distributed to the beneficiary would also be capital gain in the hands of the certificate holders. Gain or loss is also realized by the certificate holders with respect to distribution of trust principal other than proceeds of capital gain measured with respect to the certificate holder's basis in his trust certificates, and constitutes ordinary income or loss.

Advice has been requested relative to the treatment to be accorded a distribution by a trust resulting from the sale of a parcel of real property under the circumstances described below.

The business and assets of an insolvent New York title and mortgage company were taken over by the Superintendent of Insurance of New York as statutory receiver. A plan for the reorganization of the rights of the holders of mortgage certificates and a trust indenture were promulgated by the Superintendent of Insurance as provided by the Laws of New York, Chapter 745, Laws of 1933, as amended by section 6, Chapter 19 of the Laws of 1935 (also known as the Schackno Act). The assets of the company were transferred to the trust and transferable certificates of beneficial interest issued to the holders of the mortgage certificates. The trust provides for the liquidation of the trust estate in an orderly and businesslike manner and that all liquidation proceeds and income collected by the trustee, after deduction of expenses and sums required for the establishment of certain reserves, be paid over to the certificate holders, the beneficiaries of the trust. The trust is taxable as a strict trust and not as a receiver of the assets of an insolvent corporation under *New York Title & Mortgage Co. Certificate Trustees* v. *Commissioner*, 2 T. C. 990, acquiescence, C. B. 1944, 28. During the course of liquidation, the trustee sold a parcel of real property forming one of the assets of the trust and made distributions of both income and principal to the certificate holders in substantially the full amount received on the sale of the property.

Since the trust agreement provides for the current distribution of all trust income collected and moneys derived from liquidation of the trust

estate, the amount of income or capital gain realized by the trust and currently distributed to the beneficiary constitutes distributable income which is deductible by the trust under the provisions of section 162(b) of the Internal Revenue Code of 1939. That amount is includible in the gross income of the recipient for his taxable year in which or with which the taxable year of the trust ends. Capital gains, realized by the trustee on sale of the trust property, which are distributed to the beneficiary under the provisions of section 162(b) of the 1939 Code would also be capital gains in the hands of the certificate holders.

Distributions of principal of the trust, other than capital gains, are includible in the income of the beneficiary to the extent that the proceeds exceed the basis of the beneficial interest in the hands of the beneficiary. *Benjamin L. Allen* v. *Commissioner*, 49 Fed. 716, Ct. D. 417, C. B. X–2, 315 (1931), certiorari denied, 284 U. S. 655.

The distribution of trust principal by a trust to a beneficiary cannot, however, be considered a sale or exchange under section 117(a) of the Internal Revenue Code of 1939, and is, therefore, not a transaction from which capital gain or loss can arise. See *Adolph Klein* v. *Commissioner*, 15 T. C. 26, acquiescence, C. B. 1950–2, 3; *Joseph W. Frazer* v. *Commissioner*, 4 T. C. 1152, affirmed 157 Fed. (2d) 282, certiorari denied 329 U. S. 807. Accordingly, any gain or loss, realized by the certificate holders with respect to a distribution of trust principal, measured with respect to the certificate holder's basis in his trust certificates, would constitute ordinary income or loss.

SECTION 165.—EMPLOYEES' TRUSTS

REGULATIONS 118, SECTION 39.165–1: Employees' trusts.

Qualifying years of service for the purpose of a pension trust established by an association of doctors. See Rev. Rul. 56–23, page 598.

REGULATIONS 118, SECTION 39.165–6: Taxability of a beneficiary under a trust which meets the requirements of section 165(a).

Determination of amounts distributed, under a trusteed employees' pension plan for services rendered as a bona fide resident of a foreign country, which are includible in gross income of the recipient. See Rev. Rul. 56–123, page 60.

SUPPLEMENT F.—PARTNERSHIPS

SECTION 182.—TAX OF PARTNERS

REGULATIONS 118, SECTION 39.182–1: Distributive shares of partners. (Also Section 183, Section 39.183–1.) — Rev. Rul. 56–134

Where a domestic partnership is engaged in business in the United States and a foreign country and the arrangement with

respect to the drawing accounts of the partners results in a different distributive share of the partnership income with respect to the domestic and foreign branch, there are in each of such cases two common funds shared by the identical partners in different ratios and, therefore, two partnerships rather than one for Federal income tax purposes.

O. D. 140, C. B. 1, 174 (1919), affirmed; G. C. M. 13771, C. B. XIII–2, 229 (1934), and G. C. M. 17255, C. B. XV–2, 243 (1936), modified.

Advice has been requested whether O. D. 140, C. B. 1, 174 (1919), has been overruled or modified by G. C. M. 13771, C. B. XIII–2, 229 (1934), and G. C. M. 17255, C. B. XV–2, 243 (1936).

O. D. 140, *supra*, holds that "income from a particular source can not be allocated to one partner of a partnership for income tax purposes, but must be divided pro rata among the several partners."

G. C. M. 13771, *supra*, holds in part that a nonresident alien partner's distributive share of the partnership income arising from business attributable to the United States office is subject to Federal income tax, while income arising from business attributable to the foreign branch office is income from sources without the United States and is not subject to Federal income tax.

G. C. M. 17255, *supra*, which modified G. C. M. 13771, *supra*, holds that the so-called "salary" of a nonresident alien member of a domestic partnership operating in the United States and a foreign country, who devotes his time solely to the foreign branch, is part of his distributive share of partnership profits and constitutes income from sources without the United States to the extent the income of the foreign branch is available to make such distribution.

O. D. 140, *supra*, merely states the fundamental proposition that the distributive share of a partner in partnership income represents his pro rata share of each and every type of partnership income, *i. e.*, in dividing partnership income the partners will be considered as dividing all items of common income in the same proportion. For example, if one partner has a drawing account of $6,000 and the other partner a drawing account of $12,000 and they are to divide all remaining income on a 50–50 basis, $18,000 is divided between the partners 2 to 1, and any remaining income is divided between them 50–50 without regard to the source of any item included in the partnership income. In this and similar situations, it would be immaterial what services were actually performed by each partner and to what extent the source of the income was from services and to what extent it was from the employment of capital.

The stated view reflects the basic proposition that partnership income, as well as partnership property, is a single fund to be divided between the partners in the agreed ratio. Different items of income of a single partnership cannot be divided differently between the partners depending upon the source any more than can various items of property held by the partnership be conceived as being held in different ratios or being owned in different ratios by different partners. For example, if, in accordance with the partnership agreement, the partnership purchased certain assets at the direction of *A* from funds contributed by him to the partnership, and such assets were to be held for his account, it seems clear that the purchase money used to acquire

such assets was, in effect, distributed to *A* and the assets so purchased were assets owned by *A* and not the partnership, notwithstanding the partnership agreement provided that such purchase money should be continued to be regarded as partnership capital.

In view of the above, if a partnership agreement purports to make the partnership hold and operate different assets for the benefit of the partners in different ratios, there is not just one partnership but two partnerships, each with a common fund in which the partners share in the agreed ratio. By treating what purports to be the foreign branch of a domestic partnership as a separate partnership, the conclusions reched in both G. C. M. 13771, *supra*, and G. C. M. 17255, *supra*, can be reconciled with O. D. 140, *supra*. In each of those cases, a separate partnership could have been expressly formed to conduct the foreign branch business with the results indicated consistent with those reached in the two cited opinions. In that case it would have been plain that there were two common funds consistent with the basic proposition of O. D. 140, *supra*.

Since the arrangement with respect to the drawing accounts in each of the cited G. C. M.'s, *supra*, in effect results in a different distributive share of the partners as respects the domestic and foreign branch, it becomes plain under the above discussion that there is not just one common fund shared identically by partners in agreed ratios but two common funds shared by identical partners in different ratios, thereby requiring the conclusion that there is in each of those cases in reality two partnerships rather than one for Federal income tax purposes.

G. C. M. 13771 C. B. XIII-2,229 (1934), and G. C. M. 17255 C. B. XV-2, 243 (1936), are modified accordingly.

The rulings referred to herein are applicable only to the years governed by the Internal Revenue Code of 1939.

SECTION 183.—COMPUTATION OF INCOME

REGULATIONS: 118, SECTION 39.183-1: Computation of partnership income.

Computation of income received by a domestic partnership engaged in business in the United States and in a foreign country where certain adjustments affect the distribution ratios of the partners. See Rev. Rul. 56-134, page 649.

SUPPLEMENT G.—INSURANCE COMPANIES

SECTION 201.—LIFE INSURANCE COMPANIES

REGULATIONS 118, SECTION 39.201-3: Life insurance companies; definition.

Disposition of its insurance business by a life insurance company under a reinsurance agreement with another insurance company. See Rev. Rul. 56-106, page 313.

SECTION 274.—BANKRUPTCY AND RECEIVERSHIPS

REGULATIONS 118, SECTION 39.274–1: Bankruptcy and receivership proceedings. Rev. Rul. 56–162

Interest accrues on taxes due the United States during the period a taxpayer's affairs are being administered by a bankruptcy court and may be offset against a refund due the taxpayer.

Advice has been requested whether interest accrues on a Federal tax claim after the filing of a petition in bankruptcy and whether such interest may be offset against an overassessment resulting from the allowance of a claim for refund.

The taxpayer corporation was determined to be entitled to relief from excess profits tax under section 722 of the Internal Revenue Code of 1939. The resultant aggregate overassessment of excess profits tax was $90x$ dollars on which interest in the amount of $20x$ dollars was allowed. The concurrent resultant deficiency in income tax amounted to $40x$ dollars on which interest in the amount of $10x$ dollars was assessed. During a portion of the period for which interest on the overassessment of excess profits tax was allowed and interest on the deficiency in income tax was assessed, the affairs of the corporation were administered by a Federal court in connection with a petition for an arrangement under Chapter XI of the Bankruptcy Act, 11 U. S. C. 701–799.

The taxpayer corporation takes the position that it is entitled to a refund of $1x$ dollars representing the amount of the interest assessed on the deficiency in income tax applicable to the period of bankruptcy administration. In support of its position the taxpayer cites the cases of *City of New York* v. *Lewis H. Saper, Trustee et al.*, 336 U. S. 328, Ct. D. 1715, C. B. 1949–1, 120, and *United States* v. *General Engineering & Manufacturing Co.*, 188 Fed. (2d) 80, affirmed per curiam 342 U. S. 912.

In the General Engineering case it was held that,

All of the sections of the Bankruptcy Act upon which the Supreme Court relied in the Saper case in demonstrating that tax claims in bankruptcy proceedings are debts and that interest upon them is allowable only to the date of bankruptcy are equally applicable to proceedings for an arrangement under Chapter XI.

In the Saper case, the Court held that interest accruing on Federal tax claims after the date of bankruptcy could not be allowed in a bankruptcy proceeding. Some of the language of that decision may be taken to indicate that interest does not run on such claims during the period from the date of filing a petition in bankruptcy to the date of payment of the claims. The Revenue Service, however, does not believe that the holding of the Court is to that effect. From a careful analysis of the reasoning employed by the Court, it is believed that the decision recognizes that the liability for interest continues to the date of payment of the claims, but, as a matter involving equity of distribution of assets among creditors, forbids the collection of post-bankruptcy interest where the estate being administered is insufficient to meet all claims.

In the instant case, however, we are not concerned with an attempt to collect tax out of an estate being administered by a Federal court under the Bankruptcy Act. We are concerned with an adjustment of the taxpayer's liability for income and excess profits taxes, the net effect of which has been to set up overassessments of excess profits tax. In such a situation the similar provisions for computation of interest on deficiencies in income tax and overassessments of excess profits tax, as contained in section 292(b) and section 3771(g), respectively, of the Code, indicate very clearly that the computation of interest on overassessments and complementary deficiencies is a necessary step in arriving at the correct net refund or credit due a taxpayer resulting from allowance of a claim under section 722 of the Code.

It will be noted that in the Saper case the Court cited with apparent approval the cases of *American Iron and Steel Manufacturing Co.* v. *Seaboard Air Line Railway*, 233 U. S. 261, and *Sexton* v. *Dreyfus*, 219 U. S. 339, as recognizing exceptions to the rule against allowance of postbankruptcy interest. In the American Iron and Steel Manufacturing Co. case the following language of the opinion is very significant:

* * * And it is true, as held in *Tredegar Co.* v. *Seaboard Ry.*, 183 Fed. Rep. 289, 290, that as a general rule, after property of an insolvent is in *custodia legis* interest thereafter accruing is not allowed on debts payable out of the fund realized by a sale of the property. But that is not because the claims had lost their interest-bearing quality during that period, but is a necessary and enforced rule of distribution, due to the fact that in case of receiverships the assets are generally insufficient to pay debts in full. If all claims were of equal dignity and all bore the same rate of interest, from the date of receivorship to the date of final distribution, it would be immaterial whether the dividend was calculated on the basis of the principal alone or of principal and interest combined. But some of the debts might carry a high rate and some a low rate, and hence inequality would result in the payment of interest which accrued during the delay incident to collecting and distributing the funds. As this delay was the act of the law, no one should thereby gain an advantage or suffer a loss. * * *

In *Vanston Bondholders Protective Committee* v. *Green, et al.*, 329 U. S. 156, it is stated that it is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership, and reorganization has been a balance of equities between creditor and creditor or between creditors and the debtor. Thus, it seems clear that the Government has the right to set off interest, which becomes a part of and is collectible as a tax liability, due it on a tax claim, against any refund which a taxpayer may become entitled to receive as a result of allowance of a claim under section 722 of the Code. In this connection it should be noted that section 3770(a)(4) of the Code provides that in lieu of refunding an overpayment of tax, the Commissioner may credit such overpayment against any tax due from the taxpayer.

Further support for the position that the Government may set off debts due it against a refund due a taxpayer is found in the case of *Carman* v. *United States*, 21 Fed. Supp. 239, wherein it was held that section 57(j) of the Bankruptcy Act does not provide that a claim for a penalty is extinguished, but merely provides that a proof of claim may not be allowed in the case of a penalty or forfeiture with certain exceptions. It was further held that while the government might be

barred from filing a proof of claim on account of the penalty assessed, section 57(j) of the Act does not in any wise affect a penalty properly levied and retained by the United States out of funds held in its possession. The significance to the instant case is that it was a clear cut holding that the Government could set off an item which it could not collect in a bankruptcy proceeding against funds in its possession.

In view of the foregoing, it is held that interest which accrued on the deficiency in tax for the period during which the affairs of the corporation were being administered by the bankruptcy court was properly offset against the refund due the taxpayer.

SUPPLEMENT M.—INTEREST AND ADDITIONS TO THE TAX

SECTION 293.—ADDITIONS TO THE TAX IN CASE OF DEFICIENCY

Rev. Rul. 56–54

Where delinquent returns are filed showing the correct tax liability and it is found that it was the intent of the taxpayer to evade tax by fraudulent acts, the 50 percent fraud penatly under section 293(b) of the Internal Revenue Code of 1939 shall be assessed and collected from the taxpayer.

Advice has been requested whether the fraud penalty under section 293(b) of the Internal Revenue Code of 1939 should be assessed against a taxpayer who has filed a delinquent return showing the correct tax liability and it is found that he intended to evade tax by fraudulent acts.

Section 293(b) of the Internal Revenue Code of 1939 provides:

If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612(d)(2).

Section 39.271–1(a) of Regulations 118 provides that the term "deficiency" means the excess of the tax imposed by chapter one over the sum of the amount shown as the tax by the taxpayer upon his return and the amounts previously assessed (or collected without assessment) as a deficiency; but such sum shall first be reduced by the amount of rebates made. If no return is made, or if the return (except a return on Form 1040A pursuant to section 51(f) of the Code) does not show any tax, for the purposes of the definition "the amount shown as the tax by the taxpayer upon his return" shall be considered as zero.

The Tax Court of the United States interpreted section 271(a) of the Code, prior to its amendment by the Individual Income Tax Act of 1944, in the case of *Maitland A. Wilson* v. *Commissioner*, 7 T. C. 395. In that case, the taxpayer had filed a return for 1936 and paid the tax disclosed therein. Subsequently, two deficiencies were determined. The first deficiency was assessed and paid in 1939. In 1942, a deficiency notice for 1936 was mailed to the taxpayer determining a further deficiency and the fraud penalty. The penalty was based on the difference between the full tax liability for 1936 and the amount disclosed in the original return filed for that year. For 1940, the taxpayer had filed a return and thereafter filed an amended return. In 1942, a defi-

ciency notice was mailed determining a deficiency and the fraud penalty was computed in a manner similar to that followed in connection with the year 1936. The taxpayer contended that the term "deficiency," as used in section 293(b) of the Code referred to the tax remaining unpaid as set forth in the notice of deficiency. The court stated:

There is not the slightest indication in the history of section 271(a) of the 1932 and the 1934 Acts, in which the term "deficiency" is defined, that it was intended to change the existing scheme for imposing a fraud penalty and reduce the penalty imposed under prior laws by 50 percent of the amount of the understatement in tax which had been paid prior to the discovery of the fraud or the assertion of a penalty. The construction for which petitioner argues would assume an intent on the part of Congress to relieve from any penalty a taxpayer, guilty of fraud, who, finding the collector had discovered his fraud, quickly filed an amended return and paid the tax before the deficiency notice could be mailed.

The above interpretation of "deficiency" was repeated in the case of *Aaron Hirschman et al.* v. *Commissioner*, 12 T. C. 1223, in connection with section 271(a) of the 1939 Code.

Accordingly, it is held that the 50 percent fraud penalty should be assessed against a taxpayer if it is found that he intended to evade tax by fraudulent acts, even though he has filed delinquent returns showing the correct tax liability and paid the tax and interest.

SUPPLEMENT O.—OVERPAYMENTS

SECTION 322.—REFUNDS AND CREDITS

REGULATIONS 118, SECTION 39.322-7: Limitations upon crediting and refunding of taxes paid; general rule. — Rev. Rul. 56-177

G. C. M. 11650, C. B. XII-1, 325 (1933), which holds that the Internal Revenue Service is without authority to exclude from computation Sunday, the last day of the limitation period within which a claim for refund might have been filed, will continue to be followed with respect to claims for refund filed prior to August 17, 1954, notwithstanding the contrary decision in the case of *United States* v. *Charles B. Peters et al.*, 220 Fed. (2d) 544. Claims for refund filed after August 16, 1954, come within the purview of section 7503 of the Internal Revenue Code of 1954 which provides, as far as is here pertinent, that where the last day for filing a claim for refund falls on a Saturday, Sunday or legal holiday, the filing thereof on the next succeeding day which is not a Saturday, Sunday or legal holiday shall be considered as timely. See Supplemental Opinion of The Tax Court of the United States in *Glenshaw Glass Company, Inc.*, v. *Commissioner*, 25 T. C. No. 135.

(Also Section 131(a); 39.131(a)-1.) — Rev. Rul. 56-196

The election of a taxpayer to claim credit, under section 131(a) of the Internal Revenue Code of 1939, for the amount of certain taxes paid to a foreign country or to any United States possessions must be made or changed prior to the expiration of the period prescribed under Code section 322(b)(1) or (3), as the case may be, and not the special limitation period established by Code section 322(b)(6).

Advice has been requested whether the special limitation period under section 322(b)(6) of the Internal Revenue Code of 1939 may be used to determine the period within which an election may be made to claim credit for taxes paid to a foreign country under Code section 131(a), or to change such an election previously made.

Claims for refund were filed by the taxpayer for the years 1947, 1948 and 1949. The 1949 claim was allowed resulting in a net operating loss for that year, with a carryback to 1947. A credit for foreign taxes was claimed on the 1947 return but, in a claim for refund filed in 1953, the taxpayer indicated his desire to change the credit to a deduction, thus increasing its carryback to 1948.

The Internal Revenue Code of 1939 permits a taxpayer, who has paid income tax to a foreign country to deduct the tax so paid or accrued in accordance with section 23(c) thereof, or to claim a foreign tax credit under section 131(a).

Section 131(a) of the Internal Revenue Code of 1939, as amended by section 158(a) of the Revenue Act of 1942, provides that if a taxpayer chooses the benefits of that section, the tax imposed by Chapter 1 (with certain taxes excepted) shall be credited with 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 further that "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 imposed by this chapter."

Section 39.131(a)-1(d) of Regulations 118 reads in part as follows:

> The choice available to the taxpayer with respect to claiming such credit may be exercised (or changed if previously exercised) by the taxpayer at any time before the expiration of the period prescribed by statute for the making of a claim for credit or refund for the taxable year.

Section 322(b)(1) of the 1939 Code provides that a claim for credit or refund may be filed within three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid, whichever period expires later. A general extension of such period is provided for in section 322(b)(3), in cases involving waivers of the statute of limitations on assessment under section 276(b). Section 322(b)(3) was also added by the Revenue Act of 1942. See section 169(a) of such Act.

Section 322(b)(6) provides a special period of limitations with respect to filing a claim for credit or refund which may be used in lieu of the three-year period of limitations prescribed in section 322(b)(1), if such claim relates to an overpayment attributable to a net operating loss carryback. Such special period ends with the expiration of the fifteenth day of the thirty-ninth month following the end of the taxable year of the net operating loss or the unused excess profits credit which results in such carryback.

It appears that at the time of the amendment of section 131(a) of the 1939 Code by section 158(a) of the Revenue Act of 1942, permitting a taxpayer to choose between using the foreign tax as a credit or as a deduction, and prescribing the proper period for the exercise of such choice, Congress could have had reference only to the periods of

limitations, then generally applicable or made applicable by that Act, which, as indicated above, were those provided by Code section 322(b)(1) and (3). Section 322(b)(6), the special period of limitations, was not added to the Code until 1945, and then by section 5(b) of the Tax Adjustment Act of 1945.

Moreover, a refund claim filed by a taxpayer under section 322(b)(6) is allowable only to the extent such claim "relates to an overpayment attributable to a net operating loss carry-back." An overpayment attributable to the exercise of an election, such as that provided in section 131(a), is not attributable to a net operating loss carry-back within the meaning of section 322(b)(6). In view of the special and limited relief which section 322(b)(6) was designed to afford, it is the position of the Internal Revenue Service that section 322(b)(6) does not apply for purposes of section 131(a) of the Code. See H. R. Report No. 849, 79th Cong., C. B. 1945, 566 at 585.

Accordingly, it is held that the election of a taxpayer to claim credit, under section 131(a) of the Internal Revenue Code of 1939, for the amount of certain taxes paid to a foreign country or to any United States possession, must be made or changed prior to the expiration of the period prescribed under Code section 322(b)(1) or (3), as the case may be, and not by the special limitation period established by Code section 322(b)(6).

SUPPLEMENT Q.—REGULATED INVESTMENT COMPANIES

SECTION 362.—TAX ON REGULATED INVESTMENT COMPANIES

REGULATIONS 118, SECTION 39.362–2: Method of taxation of regulated investment companies.

Designation of a capital gain dividend in a multi-fund regulated investment company where such gain is the result of the transfer of securities, for cash, directly between one fund and another within the same multi-fund company. See Rev. Rul. 56–246, page 316.

SUBCHAPTER D.—EXCESS PROFITS TAX

PART I.—RATE AND COMPUTATION OF TAX

SECTION 437.—INVESTED CAPITAL CREDIT

REGULATIONS 130, SECTION 40.437–3: Adjusted invested capital.

Contributions of mutual savings and other banks to qualified pension plans and trusts which are not deducted in the current year of payment but which are carried forward and deducted in a subsequent year or years. See Rev. Rul. 56–216, page 618.

PART IV.—EXCESS PROFITS CREDIT BASED ON INCOME IN CONNECTION WITH CERTAIN TAXABLE ACQUISITIONS OCCURRING PRIOR TO DECEMBER 1, 1950

SECTION 474.—EXCESS PROFITS CREDIT BASED ON INCOME—CERTAIN TAXABLE ACQUISITIONS

REGULATIONS 130, SECTION 40.474–4: Rules for the prevention of duplication. Rev. Rul. 56–163

The "deposit liabilities" of a selling bank, assumed by the purchasing bank in a transaction described in section 474(a)(1)(A) of the Internal Revenue Code of 1939, do not constitute a bona fide long-term increase in capital structure within the meaning of section 40.474–4(a)(2)(ii) of Regulations 130. Accordingly, to the extent that duplication of base period experience occurs, an adjustment is required, under the provisions of section 40.474–4(a)(1) of Regulations 130, in determining the average base period net income of the purchasing bank upon which its excess profits credit is based.

Advice has been requested whether an adjustment is required in determining the average base period net income of a purchasing bank where the purchasing bank, in a taxable acquisition which occurred prior to December 1, 1950, assumed the "deposit liabilities" of the selling bank.

The taxpayer corporation, a bank, purchased, in 1949, substantially all of the assets of another bank, in consideration of the assumption by the purchasing corporation of an equivalent amount of the deposit liabilities of the selling corporation. After completion of the necessary formalities involved in the transfer of the assets and liabilities to the purchasing corporation, the selling corporation immediately ceased all business activities and dissolved. The purchasing bank used the entire base period experience of the selling corporation in the computation of its excess profits credit based on income. The specific question is whether the purchasing corporation was correct in including the entire base period experience of the selling corporation in determining its average base period net income upon which its excess profits credit is based.

Part IV of Subchapter D of Chapter 1 of the Internal Revenue Code of 1939 provides for the computation of the excess profits credit of a purchasing corporation in connection with certain taxable acquisitions occurring prior to December 1, 1950.

Section 40.474–4(a)(1) of Regulations 130 provides the rules to be followed in order to prevent certain duplications in base period income in cases where assets of the purchasing corporation are used to purchase properties of the selling corporation in a taxable acquisition occurring prior to December 1, 1950.

Section 40.474–4(a)(2) of Regulations 130 provides, in part, that, except to the extent that a duplication of base period experience occurs, no adjustment is necessary where stock of the purchasing corporation is issued directly to the selling corporation or the properties are ac-

quired through a bona fide increase in long-term capital structure of the purchasing corporation made in conjunction with and for the purpose of such acquisition.

In the instant case, the facts disclose that the acquisition qualifies as a Part IV transaction within the meaning of section 474(a)(1)(A) of the Internal Revenue Code of 1939. However, the assumption by the purchasing corporation of the "deposit liabilities" of the selling corporation is tantamount to the payment thereof, by use of the purchaser's assets, in order to acquire the properties of the selling corporation.

Accordingly, the "deposit liabilities" of the selling bank, assumed by the purchasing bank, do not constitute a bona fide long-term increase in capital structure within the meaning of section 40.474–4(a)(2)(ii) of Regulations 130 and, to the extent that duplication of base period experience occurs, an adjustment is required under the provisions of section 40.474–4(a)(1) of Regulations 130 in determining the average base period net income of the purchasing bank upon which its excess profits credit is based.

CHAPTER E.—ESTATE TAX

SUBCHAPTER A.—BASIC ESTATE TAX

PART II.—ESTATES OF CITIZENS OR RESIDENTS OF THE UNITED STATES

SECTION 811(g).—GROSS ESTATE: PROCEEDS OF LIFE INSURANCE

REGULATIONS 105, SECTION 81.27: Insurance receivable by other beneficiaries. Rev. Rul. 56–250

In *Anne Harley Kohl and William J. Harley, Executors, Estate of William S. Harley*, v. *United States*, 226 Fed (2d) 381, the court held that to apply the provisions of section 811(g) of the Internal Revenue Code of 1939, as amended by section 404 of the Revenue Act of 1942, to the proceeds of the insurance policies involved in that case would result in a direct tax without the apportionment required by Article 1, Section 2, and Article 1, Section 9, of the Constitution of the United States, and would result in retroactive taxation in violation of the Fifth Amendment to the Constitution. Although, due to certain procedural defects, review of the question by the Supreme Court of the United States was not sought, the decision will not be considered by the Internal Revenue Service as a precedent in the disposition of other cases involving a similar factual situation.

SECTION 812(b).—NET ESTATE: EXPENSES, LOSSES, INDEBTEDNESS, AND TAXES

REGULATIONS 105, SECTION 81.37: Taxes. Rev. Rul. 56-6

Deficiencies in Federal income taxes assessed against the decedent resulting from nonrecognition of his minor son as a member of a partnership are deductible from decedent's gross estate in the full amount paid by decedent's estate.

Advice has been requested relative to the amount allowable as a deduction from the decedent's gross estate for deficiencies in Federal income taxes assessed against the decedent resulting from a determination by the Internal Revenue Service that the decedent's minor son may not be recognized as a member of an alleged family partnership.

The decedent made a purportedly absolute transfer of an interest in his business to his minor son. He filed a gift tax return for the year of the alleged transfer, reporting a gift to his son. Thereafter, the business was conducted in partnership form. However, for certain years decedent's minor son was not recognized as a member of a partnership for Federal income tax purposes, but no action was taken in a State court to declare the partnership invalid as to the son. Deficiencies in Federal income taxes were assessed against the decedent's estate and overassessments of tax were credited to the son. It appears that the deficiencies are collectible in full from the estate, the son's guardian not having consented to crediting the overassessments, which have been refunded to the guardian for the benefit of the son, and no part thereof was loaned or used for the benefit of the decedent's estate. No transferee liability of the son for the deficiencies was asserted.

Section 812(b) of the Internal Revenue Code of 1939 authorizes the allowance of deductions for claims against the estate, but such deductions do not include any income taxes upon income received after the death of the decedent. Section 81.37 of Estate Tax Regulations 105 provides that unpaid taxes upon income received during the decedent's lifetime are deductible but taxes upon income received after death are not deductible. The value of the gross estate includes the value of all property to the extent of the interest therein of the decedent at the time of his death and encompasses any valid claims against others, but in the circumstances of the present case it appears that no claim of the estate against the son or his guardian exists or is asserted.

Accordingly, it is held that the estate is entitled to a deduction under section 812(b) of the Internal Revenue Code of 1939 for the full amount of the income taxes of the decedent assessed against the estate and paid out of the assets of the estate.

SECTION 813(b).—CREDITS AGAINST TAX: ESTATE, SUCCESSION, LEGACY, AND INHERITANCE TAXES

REGULATIONS 105, SECTION 81.9: Credit for death taxes. Rev. Rul. 56-230

A nonresident not a citizen of the United States at the time of his death owned real property in State *A* and intangible personal property situated in State *B*, all of which was included in his gross estate and subjected to the Federal estate tax. Both States specifically ex-

empt from death taxes intangibles in the estate of a decedent who was not domiciled in the State at the time of his death. The applicable statute of State *A* imposes an estate tax plus an additional estate tax which is intended to take advantage of the maximum credit allowable against the Federal estate tax under section 813(b) of the Internal Revenue Code of 1939. State *A* has interpreted its additional estate tax statute in the instant case to require the estate to pay the entire difference between the estate tax and the full Federal credit allowable under section 813(b). The estate has expressed its willingness to pay the tax assessed by State *A* if it will receive a credit under section 813(b).

State *A* has no power to tax the transfer of intangible personal property of the decedent's estate which lies outside its jurisdiction. *Frick, et al.* v. *Pennsylvania*, 268 U. S. 473; *Curry* v. *McCanless*, 307 U. S. 357; *Graves* v. *Elliott*, 307 U. S. 383; *Utah* v. *Aldrich*, 316 U. S. 174. Furthermore, a State being without the power to tax directly the transfer of property outside its jurisdiction, it cannot accomplish the same thing indirectly by taking the whole of the decedent's estate as the basis for measuring the tax on the transfer of that part of the estate which lies within its jurisdiction. *Treichler, Executor* v. *Wisconsin*, 338 U. S. 251. It will be the policy of the Internal Revenue Service to disallow as a credit the full amount of the additional estate tax which State *A* has asserted in the instant case and in all other cases where the State is asserting a tax not in consonance with the decision in *Treichler, Executor* v. *Wisconsin, supra*, except in any case where payments were made before November 7, 1949, the date of the decision in the *Treichler* case, and it was impossible thereafter to obtain a refund of the tax. Accordingly, the allowance of credit under section 813(b) of the 1939 Code is limited in the instant case and will be limited in all other similar cases to the proportion of the full Federal credit allowable to the estate which is attributable to that part of the gross estate situated in State *A*.

CHAPTER 9.—EMPLOYMENT TAXES

SUBCHAPTER A.—EMPLOYMENT BY OTHERS THAN CARRIERS

PART III.—GENERAL PROVISIONS

SECTION 1426(b).—DEFINITIONS: EMPLOYMENT

REGULATIONS 128, SECTION 408.216: Religious, charitable, educational, or other organizations exempt from income tax under section 101(6) of the Internal Revenue Code. T. D. 6176

TITLE 26—INTERNAL REVENUE, 1939.—CHAPTER I, SUBCHAPTER D, PART 408.—EMPLOYEE TAX AND EMPLOYER TAX UNDER THE FEDERAL INSURANCE CONTRIBUTIONS ACT; APPLICABLE ON AND AFTER JANUARY 1, 1951

Regulations 128 amended to conform to section 403 of the Social Security Amendments of 1954, approved September 1, 1954, relating to services for certain tax-exempt organizations.

[1] 21 F. R. 3647.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On March 14, 1956, notice of proposed rulemaking regarding amendments to conform Regulations 128 (26 CFR (1939) part 408), as amended, relating to the employee tax and the employer tax under the Federal Insurance Contributions Act (subchapter A, chapter 9, Internal Revenue Code of 1939), to the provisions of section 403 of the Social Security Amendments of 1954 (68 Stat. 1098), approved September 1, 1954, was published in the Federal Register (21 F. R. 1598). No objection to the rules proposed having been received during the 30-day period prescribed in the notice, the following amendments to such regulations are hereby adopted:

PARAGRAPH 1. Section 408.201 is amended by inserting after paragraph (q) the following new paragraph:

(r) "Social Security Amendments of 1954" means the Act approved September 1, 1954 (68 Stat. 1052).

PAR. 2. There is inserted immediately preceding § 408.216 the following:

SECTION 403 OF THE SOCIAL SECURITY AMENDMENTS OF 1954, APPROVED SEPTEMBER 1, 1954

Service for Certain Tax-Exempt Organizations Prior to Enactment of This Act

(a) In any case in which—

(1) an individual has been employed, at any time subsequent to 1950 and prior to the enactment of this Act, by an organization which is exempt from income tax under section 101(6) of the Internal Revenue Code of 1939 but which has failed to file prior to the enactment of this Act a waiver certificate under section 1426(*l*)(1) of the Internal Revenue Code of 1939;

(2) the service performed by such individual as an employee of such organization during the period subsequent to 1950 and prior to 1955 would have constituted employment (as defined in section 210 of the Social Security Act and section 1426(b) of the Internal Revenue Code of 1939) if such organization had filed prior to the performance of such service such a certificate accompanied by a list of the signatures of employees who concurred in the filing of such certificate and such individual's signature had appeared on such list;

(3) the taxes imposed by sections 1400 and 1410 of the Internal Revenue Code of 1939 have been paid with respect to any part of the remuneration paid to such individual by such organization for such service;

(4) part of such taxes have been paid prior to the enactment of this Act;

(5) so much of such taxes as have been paid prior to the enactment of this Act have been paid by such organization in good faith and upon the assumption that a waiver certificate had been filed by it under section 1426(*l*)(1) of the Internal Revenue Code of 1939; and

(6) no refund of such taxes has been obtained,

the amount of such remuneration with respect to which such taxes have been paid shall, upon the request of such individual (filed in such form and manner, and with such official, as may be prescribed by regulations made under subchapter A of Chapter 9 of the Internal Revenue Code of 1939), be deemed to constitute remuneration for employment as defined in section 210 of the Social Security Act and section 1426(b) of the Internal Revenue Code of 1939.

(b) In any case in which—

(1) an individual has been employed, at any time subsequent to 1950 and prior to the enactment of this Act, by an organization which has filed a

waiver certificate under section 1426(*l*)(1) of the Internal Revenue code of 1939;

(2) the service performed by such individual during the time he was so employed would have constituted employment (as defined in section 210 of the Social Security Act and section 1426(b) of the Internal Revenue Code of 1939) if such individual's signature had appeared on the list of signatures of employees who concurred in the filing of such certificate;

(3) the taxes imposed by sections 1400 and 1410 of the Internal Revenue Code of 1939 have been paid prior to the enactment of this Act with respect to any part of the remuneration paid to such individual by such organization for such service; and

(4) no refund of such taxes has been obtained,

the amount of such remuneration with respect to which such taxes have been paid shall, upon the request of such individual (filed on or before January 1, 1957, and in such form and manner, and with such official, as may be prescribed by regulations made under subchapter A of chapter 9 of the Internal Revenue Code of 1939), be deemed to constitute remuneration for employment as defined in section 210 of the Social Security Act and section 1426(b) of the Internal Revenue Code of 1939, and such individual shall be deemed to have concurred in the filing of the waiver certificate filed by such organization under section 1426(*l*)(1) of the Internal Revenue Code of 1939.

PAR. 3. Section 408.216 is amended as follows:

(A) By revising the first paragraph of § 408.216(a) (26 CFR 408.216(a)(1)) to read as follows:

Services performed by an employee in the employ of a religious, charitable, educational, or other organization exempt from income tax under section 101(6) of the Internal Revenue Code are excepted from employment. However, this exception does not apply to services (1) performed during the period for which a certificate, filed pursuant to section 1426(*l*) of the Act, is in effect if such services are performed by an employee (i) whose signature appears, or is deemed pursuant to section 403(b) of the Social Security Amendments of 1954 and paragraph (d) of this section to appear, on the list filed by such organization under section 1426(*l*) of the Act, or (ii) who became an employee of such organization after the calendar quarter in which the certificate was filed; or (2) with respect to which the employee and employer taxes have been paid and a request is thereafter filed under the conditions stated in paragraph (c) (1) and (2) of this section.

(B) By revising the first and second sentences of the last undesignated paragraph of § 408.216(b)(2) (26 CFR 408.216(b)(2)(v)) to read as follows:

Services performed in the employ of an organization which has duly filed a certificate are not excepted from employment under section 1426(b)(9)(B) of the Act, during the period for which the certificate is in effect, if such services are performed by an employee (i) whose signature appears, or is deemed pursuant to section 403(b) of the Social Security Amendments of 1954 and paragraph (d) of this section to appear, on the list filed by the organization on Form SS–15a, or on Form SS–15a Supplement, or (ii) who becomes an employee of the organization after the calendar quarter in which the certificate is filed. Consequently, the taxes imposed under the Act will apply to the organization and to each employee whose services constitute employment and whose signature appears, or is deemed pursuant to section 403(b) of the Social Security Amendments of 1954 and paragraph (d) of this section to appear, on the accompanying list or on any supplemental list or lists filed within the prescribed time, commencing with the first day following the close of the calendar quarter in which the certificate is filed.

(C) By adding at the end thereof the following new paragraphs:

(c) *Special procedure for coverage of certain services in cases where waiver was not filed prior to September 1, 1954.*—(1) *In general.*—Pursuant to section 403(a) of the Social Security Amendments of 1954, any individual who, as an employee, performed services after December 31, 1950, and prior to September 1, 1954, for an organization exempt from income tax under section 101(6) of the

Internal Revenue Code which had failed to file, prior to September 1, 1954, a valid certificate under section 1426(*l*) of the Act, may request that the remuneration received by him for services performed in the employ of the organization after 1950 and before 1955 be deemed to constitute remuneration for employment for purposes of the taxes imposed under the Act and for purposes of title II of the Social Security Act, if—

(i) Any of the services performed by the individual after December 31, 1950, and prior to January 1, 1955, would have constituted employment, as defined in section 1426(b) of the Act, if a certificate on Form SS–15 filed by the organization under section 1426(l) of the Act had been in effect for the period during which the services were performed and the individual's signature had appeared on the accompanying list on Form SS–15a;

(ii) The employee and employer taxes have been paid with respect to any part of the remuneration received by the individual from the organization for such services;

(iii) A part of such taxes was paid prior to September 1, 1954;

(iv) Such taxes as were paid before September 1, 1954, were paid by the organization in good faith and upon the assumption that it had filed a valid certificate under section 1426(l) of the Act; and

(v) No refund (or credit) of such taxes has been obtained either by the employee or the employer, exclusive of any refund (or credit) which would be allowable if the services performed by the individual had constituted employment.

The provisions of section 403(a) of the Social Security Amendments of 1954 have no application to remuneration for services performed after 1954.

(2) *Execution and filing of request.*—(i) Except where the alternative procedure set forth in subdivision (ii) of this subparagraph is followed, the request of an individual under section 403(a) of the Social Security Amendments of 1954 shall be made and filed as provided in this subdivision. The request shall be in writing, shall be signed and dated by the individual, and shall include—

(*a*) The name and address of the organization for which the services were performed;

(*b*) The name, address, and social security account number of the individual;

(*c*) A statement that the individual has not obtained refund or credit (other than a refund or credit which would be allowable if the services had constituted employment) from the district director of any part of the employee tax paid with respect to remuneration received by him from the organization for services performed after 1950 and before 1955; and

(*d*) A request that all remuneration received by him from the organization for such services with respect to which employee and employer taxes have been paid shall be deemed to constitute remuneration for employment to the extent authorized by section 403(a) of the Social Security Amendments of 1954.

The request of an individual shall be accompanied by a statement of the organization incorporating the substance of each of the five conditions listed in subparagraph (1) of this paragraph. The statement of the organization should also show that the individual performed services for the organization after December 31, 1950, and prior to September 1, 1954; that the organization was exempt from income tax under section 101(6) of the Internal Revenue Code and failed to file, prior to September 1, 1954, a valid certificate under section 1426(l) of the Act; and the District Director with whom returns on Form 941 are filed. Such statement must be signed by the president or other principal officer of the organization who shall certify that the statement is correct to the best of his knowledge and belief. If the statement of the organization is not submitted with the individual's request, the individual shall include in his request an explanation of his inability to submit such statement. Other information may be required, but should be submitted only upon receipt of a specific request therefor. No particular form is prescribed for the request of the individual or the statement of the organization required to be submitted with the request. The individual's request should be filed with the District Director with whom the organization files returns on Form 941. If the individual is deceased or mentally incompetent and the request filed pursuant to section 403(a) of the Social Se-

curity Amendments of 1954 is made by the legal representative of the individual or other person authorized to act on his behalf, the request must be accompanied by evidence showing such person's authority to make the request.

(ii) An organization which has or had in its employ individuals with respect to whom section 403(a) of the Social Security Amendments of 1954 is applicable may, if it so desires, prepare a form or forms for use by any such individual or individuals in making requests under such section. Any such form shall provide space for the signature of the individual or individuals and shall contain such information as is required by subdivision (i) of this subparagraph to be included in a request. Any such form used by more than one individual, and any such form used by one individual which is signed and returned to the organization, shall be submitted by the organization, together with its statement (as required in subdivision (i) of this subparagraph), to the district director with whom the organization files returns on Form 941. An individual is not required to use a form prepared by the organization but may, at his election, file his request in accordance with the provisions of subdivision (i) of this subparagraph.

(3) *Optional tax payments by organization.*—An organization which, prior to September 1, 1954, has reported and paid taxes under the Act with respect to any portion of the remuneration paid to an individual, who is eligible to file a request under section 403(a) of the Social Security Amendments of 1954, for services performed by him subsequent to 1950 and prior to 1955, may report and pay taxes under the Act on or after September 1, 1954, with respect to any remaining portion of such remuneration which would have constituted wages if a certificate had been in effect with respect to such services. Such taxes may be reported as an adjustment without interest in the manner prescribed in subpart G of the regulations in this part. The statement in explanation of such adjustment should include a reference to section 403(a) of the Social Security Amendments of 1954.

(4) *Effect of request.*—If a request is made and filed under the conditions stated in subparagraphs (1) and (2) of this paragraph with respect to one or more individuals, remuneration for services performed by each such individual subsequent to 1950 and prior to 1955, with respect to which the employee and employer taxes are paid on or before the date on which the request is filed with the District Director, will be deemed to constitute remuneration for employment to the extent that such services would have constituted employment as defined in section 1426(b) of the Act if a certificate had been in effect with respect to such services. However, the provisions of section 1426(a) of the Act and §§ 408.226 and 408.227 of the regulations in this part are applicable in determining the extent to which such remuneration for employment constitutes wages for purposes of the employee and employer taxes.

(d) *Special procedure for coverage of certain services in cases where individual failed to sign list of concurring employees.*—(1) *In general.*—Pursuant to section 403(b) of the Social Security Amendments of 1954, any individual who, as an employee, performed services after December 31, 1950, and prior to September 1, 1954, for an organization which filed a valid certificate under section 1426(1) of the Act, but who failed to sign the list of employees concurring in the filing of such certificate, may request that the remuneration received by him for such services be deemed to constitute remuneration for employment for purposes of the taxes imposed under the Act and for purposes of title II of the Social Security Act, if—

(i) Any of the services performed by the individual after December 31, 1950, and prior to September 1, 1954, would have constituted employment, as defined in section 1426(b) of the Act, if his signature had appeared on the list of employees who concurred in the filing of the certificate;

(ii) The employee and employer taxes were paid prior to September 1, 1954, with respect to any part of the remuneration received by the individual from the organization for such services; and

(iii) No refund (or credit) of such taxes has been obtained either by the employee or the employer, exclusive of any refund (or credit) which would be allowable if the services performed by the individual had constituted employment.

(2) *Effect of request.*—An individual who makes and files a request under the conditions stated in subparagraphs (1) and (3) of this paragraph with respect to services performed as an employee of an organization exempt from income

tax under section 101(6) of the Internal Revenue Code will be deemed to have signed the list accompanying the certificate filed by the organization under section 1426(1) of the Act. Accordingly, all services performed by the individual for the organization on and after the effective date of the certificate will constitute employment to the same extent as if he had, in fact, signed the list. The employee tax and employer tax are applicable with respect to any remuneration paid to the employee by the organization which constitutes wages. If less than the correct amount of such taxes has been paid, the additional amount due should be reported as an adjustment without interest within the time specified in subpart G of the regulations in this part. The statement in explanation of such adjustment should include a reference to section 403(b) of the Social Security Amendments of 1954.

(3) *Execution and filing of request.*—(i) Except where the alternative procedure set forth in subdivision (ii) of this subparagraph is followed, the request of an individual under section 403(b) of the Social Security Amendments of 1954 shall be made and filed as provided in this subdivision. The request shall be filed on or before January 1, 1957, shall be in writing, shall be signed and dated by the individual, and shall include—

(*a*) The name and address of the organization for which the services were performed;

(*b*) The name, address, and social security account number of the individual;

(*c*) A statement that the individual has not obtained a refund or credit (other than a refund or credit which would be allowable if the services had constituted employment) from the District Director of any part of the employee tax paid before September 1, 1954, with respect to remuneration received by him from the organization;

(*d*) A request that all remuneration received by the individual from the organization for services performed after 1950 and before September 1, 1954, with respect to which employee and employer taxes were paid before September 1, 1954, shall be deemed to constitute remuneration for employment to the extent authorized by section 403(b) of the Social Security Amendments of 1954; and

(*e*) A statement that the individual understands that, upon the filing of such request with the district director, (*1*) he will be deemed to have concurred in the certificate which was previously filed by the organization, and (*2*) the employee and employer taxes will be applicable to all wages received, and to be received, by him for services performed for the organization on or after the effective date of such certificate to the extent that such taxes would have been applicable if he had signed the list on Form SS–15a submitted with the certificate.

The request of an individual shall be accompanied by a statement of the organization incorporating the substance of each of the three conditions listed in subparagraph (1) of this paragraph. The statement of the organization should also show that the individual performed services for the organization after December 31, 1950, and prior to September 1, 1954; that the organization filed a valid certificate under section 1426(1) of the Act; and the district director with whom returns on Form 941 are filed. Such statement must be signed by the president or other principal officer of the organization who shall certify that the statement is correct to the best of his knowledge and belief. If the statement of the organization is not submitted with the individual's request, the individual shall include in his request an explanation of his inability to submit such statement. Other information may be required, but should be submitted only upon receipt of a specific request therefor. No particular form is prescribed for the request of the individual or the statement of the organization required to be submitted with the request. The individual's request should be filed with the district director with whom the organization files returns on Form 941. If the individual is deceased or mentally incompetent and the request filed pursuant to section 403(b) of the Social Security Amendments of 1954 is made by the legal representative of the individual or other person authorized to act on his behalf, the request must be accompanied by evidence showing such person's authority to make the request.

(ii) An organization which has or had in its employ individuals with respect to whom section 403(b) of the Social Security Amendments of 1954 is applicable, may, if it so desires, prepare a form or forms for use by any such individual or

individuals in making requests under such section. Any such form shall provide space for the signature of the individual or individuals and shall contain such information as is required by subdivision (i) of this subparagraph to be included in a request. Any such form used by more than one individual, and any such form used by one individual which is signed and returned to the organization, shall be submitted by the organization, together with its statement (as required in subdivision (i) of this subparagraph), to the District Director with whom the organization files returns on Form 941. An individual is not required to use a form prepared by the organization but may, at his election, file his request in accordance with the provisions of subdivision (i) of this subparagraph.

(This Treasury Decision is issued under the authority contained in sections 1429 and 3791 of the Internal Revenue Code of 1939 (53 Stat. 178, 467; 26 U. S. C. 1429, 3791) and section 403 of the Social Security Amendments of 1954 (68 Stat. 1098), approved September 1, 1954.)

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved May 24, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Filed by the Division of the Federal Register May 28, 1956, 8:46 a. m.)

SECTION 1426(l).—DEFINITIONS: EXEMPTION OF RELIGIOUS, CHARITABLE, ETC., ORGANIZATIONS

REGULATIONS 128, SECTION 408.216: Religious, charitable, educational, or other organizations exempt from income tax under section 101(6) of the Internal Revenue Code. Rev. Rul. 56–121

Circumstances involving a change in entity under which all the conditions prescribed by section 403(a) of the Social Security Amendments of 1954 are not present, thereby excluding the employees of an organization from benefiting under the provisions of that section.

The Internal Revenue Service has been requested to determine whether, under the circumstances stated below, remuneration paid to employees of an organization exempt from Federal income tax under section 101(6) of the 1939 Code, for certain services performed after 1950 and prior to 1955, may, pursuant to the provisions of section 403(a) of the Social Security Amendments of 1954, C. B. 1954–2, 603, be deemed to constitute remuneration for employment for purposes of the Federal Insurance Contributions Act (subchapter A, chapter 9, Internal Revenue Code of 1939).

The *M* hospital, originally organized as a community-sponsored corporation, was granted exemption from Federal income tax under section 101(6) of the Internal Revenue Code of 1939. Its employees became eligible for social security coverage as of January 1, 1951, upon compliance by the hospital with the provisions of section 1426(l)(1) of the Federal Insurance Contributions Act. On July 1, 1953, the directors of the hospital turned over its assets, operation, and management to the *N* corporation. The transfer was made subject to the conditions that the hospital properties should remain under the control

of a nonprofit organization and that such properties should always be operated as a community hospital. In the event these conditions should not be carried out, provision was made for the hospital to revert to the grantor corporation. The hospital continued to be operated under the same management as formerly, and continued to withhold and report the Federal Insurance Contributions Act taxes on its employees under the belief that the waiver certificate filed by it, pursuant to section 1426(1)(1), *supra*, was still in effect.

In December 1953, the *M* hospital filed a new waiver after receipt of advice from the District Director of Internal Revenue that, in view of the change in entity, the original waiver was no longer effective. This new waiver was also held to be ineffective since the hospital was considered to have become an unincorporated activity of the *N* corporation, which corporation had not waived its exemption from the Federal Insurance Contributions Act taxes accorded by section 1426(b)(9)(B) of such Act. The *M* hospital was incorporated on December 1, 1954, as a separate organization and subsequently filed a new waiver which became effective on January 1, 1955.

Section 403(a) of the Social Security Amendments of 1954 provides, in general, that an individual, who as an employee performed services after December 31, 1950, and prior to September 1, 1954, for an organization exempt from Federal income tax under section 101(6) of the Internal Revenue Code of 1939, which had failed to file, prior to September 1, 1954, a valid Certificate Waiving Exemption From Taxes under the Federal Insurance Contributions Act, Form SS–15, may request that the remuneration received by him for services performed for the organization after 1950 and before 1955 be deemed to constitute remuneration for employment for purposes of the taxes imposed under the Federal Insurance Contributions Act. In order that the remuneration may be deemed to be remuneration for employment, it is necessary that the following requirement, among the others enumerated in section 403(a), *supra*, be met:

> So much of such taxes as have been paid prior to the enactment of this Act have been paid by such organization in good faith and upon the assumption that a waiver certificate had been filed by it under section 1426(1)(1) of the Internal Revenue Code of 1939;

Inasmuch as the *N* corporation was the actual employing entity of the individuals who performed services for the *M* hospital during the period from July 1, 1953 to December 1, 1954, and since such corporation had not waived its exemption from the Federal Insurance Contributions Act taxes, it cannot be said that the taxes paid in the name of the *M* hospital were paid under the assumption that a valid waiver certificate had been filed by the *N* corporation under section 1426(1)(1), *supra*. Therefore, it is held that in the instant case all the requirements prescribed by section 403(a), *supra*, have not been met and, consequently, the remuneration received by the employees for services performed in connection with the operation and management of the *M* hospital during the period in question may not be deemed to constitute remuneration for employment for purposes of the taxes imposed under the Federal Insurance Contributions Act.

SUBCHAPTER B.—EMPLOYMENT BY CARRIERS

PART I.—TAX ON EMPLOYEES

SECTION 1500.—RATE OF TAX

REGULATIONS 114, SECTION 411.301: Measure of employees' tax. T. D. 6168 [1]

(Also Sections 1501, 1510, 1520; Sections 411.303, 411.501, 411.401.)

TITLE 26—INTERNAL REVENUE. 1939.—CHAPTER 1, SUBCHAPTER D, PART 411.—EMPLOYERS' TAX, EMPLOYEES' TAX, AND EMPLOYEE REPRESENTATIVES' TAX UNDER THE RAILROAD RETIREMENT TAX ACT

Regulations 114 amended to conform to sections 201, 202, 203, 204, 205, and 402 of the Act of August 31, 1954, and to the decision in *Shattuck* v. *Gallagher*, 218 F. 2d 428.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

In order to conform Regulations 114 (26 CFR (1939) Part 411), relating to the employers' tax, employees' tax, and employee representatives' tax under the Railroad Retirement Tax Act (subchapter B, chapter 9, Internal Revenue Code of 1939), to sections 201, 202, 203, 204, 205, and 402 of the Act of August 31, 1954 (68 Stat. 1040, 1042) [C. B. 1954–2, 602] and to the decision in *Shattuck* v. *Gallagher* (C. A. 6th 1955) 218 F. 2d 428, relating to the measure of the employee representatives' tax, such regulations are amended as follows:

PARAGRAPH 1. Immediately preceding the caption "SECTION 3797 (a) AND (b) OF THE INTERNAL REVENUE CODE" as set forth preceding section 411.201, the following is inserted:

SECTION 205 OF THE ACT OF AUGUST 31, 1954 (68 STAT. 1040)

Subsection (e) of section 1532 of the Railroad Retirement Tax Act is hereby amended by inserting at the end thereof the following sentence: "Compensation for service as a delegate to a national or international convention of a railway labor organization defined as an 'employer' in subsection (a) of this section shall be disregarded for purposes of determining the amount of taxes due pursuant to this subchapter if the individual rendering such service has not previously rendered service, other than as such a delegate, which may be included in his 'years of service' for purposes of the Railroad Retirement Act."

SECTION 402 OF THE ACT OF AUGUST 31, 1954 (68 STAT. 1042)

The provisions of sections * * * 205 * * * of this Act shall be effective with respect to compensation paid on and after April 1, 1954.

PAR. 2. Immediately preceding the caption "SECTION 1511 OF THE ACT" as set forth preceding section 411.205, the following is inserted:

SECTION 205 OF THE ACT OF AUGUST 31, 1954 (68 STAT. 1040)

Subsection (e) of section 1532 of the Railroad Retirement Tax Act is hereby amended by inserting at the end thereof the following sentence: "Compensation for service as a delegate to a national or international

[1] 21 F. R. 2327.

convention of a railway labor organization defined as an 'employer' in subsection (a) of this section shall be disregarded for purposes of determining the amount of taxes due pursuant to this subchapter if the individual rendering such service has not previously rendered service, other than as such a delegate, which may be included in his 'years of service' for purposes of the Railroad Retirement Act."

SECTION 402 OF THE ACT OF AUGUST 31, 1954 (68 STAT. 1042)

The provisions of sections * * * 205 * * * of this Act shall be effective with respect to compensation paid on and after April 1, 1954.

PAR. 3. Immediately preceding the caption "SECTION 1532(e) OF THE ACT" as set forth preceding section 411.301, the following is inserted:

SECTION 201 OF THE ACT OF AUGUST 31, 1954 (68 STAT. 1040)

Section 1500 of the Railroad Retirement Tax Act is hereby amended by inserting after the word "month" the following: "before July 1, 1954, and as is not in excess of $350 for any calendar month after June 30, 1954".

PAR. 4. Immediately preceding section 411.301, the following is inserted:

SECTION 205 OF THE ACT OF AUGUST 31, 1954 (68 STAT. 1040)

Subsection (e) of section 1532 of the Railroad Retirement Tax Act is hereby amended by inserting at the end thereof the following sentence: "Compensation for service as a delegate to a national or international convention of a railway labor organization defined as an 'employer' in subsection (a) of this section shall be disregarded for purposes of determining the amount of taxes due pursuant to this subchapter if the individual rendering such service has not previously rendered service, other than as such a delegate, which may be included in his 'years of service' for purposes of the Railroad Retirement Act."

SECTION 402 OF THE ACT OF AUGUST 31, 1954 (68 STAT. 1042)

The provisions of sections * * * 205 * * * of this Act shall be effective with respect to compensation paid on and after April 1, 1954.

PAR. 5. Section 411.301 is amended as follows:

(A) By striking "paragraph (b)" in the first sentence of paragraph (a) and inserting in lieu thereof "paragraphs (b) and (c)".

(B) By striking "1946." at the end of the first sentence of paragraph (a) and inserting in lieu thereof "December 31, 1946, and before July 1, 1954, and excluding the amount of compensation in excess of $350 which is paid after December 31, 1946, to the employee for services rendered during any one calendar month after June 30, 1954."

(C) By adding at the end thereof the following new paragraph:

(c) *Exception; delegate to national or international convention of railway-labor-organization employer.*—Compensation paid on and after April 1, 1954, for service as a delegate to a national or international convention of a railway-labor-organization employer shall be disregarded for the purpose of determining the employees' tax if the individual rendering such service has not previously rendered service, other than as such a delegate, which may be included in his "years of service" for purposes of the Railroad Retirement Act of 1937.

PAR. 6. Immediately preceding the caption "SECTION 3661 OF THE INTERNAL REVENUE CODE" as set forth preceding section 411.303, the following is inserted:

SECTION 202 OF THE ACT OF AUGUST 31, 1954 (68 STAT. 1040)

Section 1501 of the Railroad Retirement Tax Act is hereby amended by inserting after the figure "300" where it first appears the following: "for any month before July 1, 1954, or in excess of $350 for any month after June 30, 1954"; and by inserting after the figure "300" where it

appears the second time, the following: "if such month is before July 1, 1954, or is less than $350 if such month is after June 30, 1954".

PAR. 7. Section 411.303(b) is amended as follows:

(A) By revising the heading to read "*Collection; aggregate monthly compensation paid by two or more employers exceeds maximum taxable compensation.*"

(B) By striking "after 1946" in that part of section 411.303 (b) which precedes subparagraph (1) and inserting in lieu thereof "after December 31, 1946, and before July 1, 1954".

(C) By striking the parenthetical sentence appearing immediately after subparagraph (6).

(D) By adding at the end thereof the following:

If an employee is paid compensation after December 31, 1946, by two or more employers for services rendered during any one calendar month after June 30, 1954, and if the aggregate compensation paid to such employee after December 31, 1946, by all employers for services rendered during such month is in excess of $350, the employees' tax to be deducted by each employer from the compensation as and when paid by him to the employee shall be determined in accordance with the provisions of subparagraphs (1) through (6) above, except that the determination shall be made with reference to $350 rather than $300.

(For provisions relating to the circumstances under which certain compensation is to be disregarded for the purpose of determining the employees' tax, see section 411.301(b) and (c).)

PAR. 8. Section 411.303(e) is amended by inserting the following immediately after the second sentence:

With respect to that part of the compensation earned by any employee for the month of July 1954 or for the period August 1 through August 30, 1954, which is in excess of $300 but not more than $350, the employer shall be liable for the employees' tax only to the extent that the employer has under his control at any time subsequent to August 30, 1954, amounts of compensation earned at any time by the employee.

PAR. 9. Immediately preceding the caption "SECTION 1532(e) OF THE ACT" as set forth preceding section 411.401, the following is inserted:

SECTION 204 OF THE ACT OF AUGUST 31, 1954
(68 STAT. 1040)

Section 1520 of the Railroad Retirement Tax Act is hereby amended by inserting after the word "month" where it first appears the phrase: "before July 1, 1954"; by inserting after the figure "$300" where it first appears the following: ", and for any calendar month after June 30, 1954, not in excess of $350"; by inserting after the phrase "shall apply" where it first appears the phrase: ", with respect to any calendar month before July 1, 1954,"; by inserting after the figure "300" where it appears the second time, the phrase: ", and with respect to any calendar month after June 30, 1954, to not more than $350,"; and by inserting after the figure "300" where it appears the third time the phrase: "if the month is before July 1, 1954, or is less than $350 if the month is after June 30, 1954".

PAR. 10. Immediately preceding section 411.401, the following is inserted:

SECTION 205 OF THE ACT OF AUGUST 31, 1954
(68 STAT. 1040)

Subsection (e) of section 1532 of the Railroad Retirement Tax Act is hereby amended by inserting at the end thereof the following sentence: "Compensation for service as a delegate to a national or international convention of a railway labor organization defined as an 'employer' in subsection (a) of this section shall be disregarded for purposes of de-

termining the amount of taxes due pursuant to this subchapter if the individual rendering such service has not previously rendered service, other than as such a delegate, which may be included in his 'years of service' for purposes of the Railroad Retirement Act."

SECTION 402 OF THE ACT OF AUGUST 31, 1954
(68 STAT. 1042)

The provisions of sections * * * 205 * * * of this Act shall be effective with respect to compensation paid on and after April 1, 1954.

PAR. 11. Section 411.401 is amended as follows:

(A) By striking "1946." at the end of the first sentence of paragraph (a) and inserting in lieu thereof "December 31, 1946, and before July 1, 1954, and excluding the amount of compensation in excess of $350 which is paid after December 31, 1946, by the employer to any employee for services rendered during any one calendar month after June 30, 1954."

(B) By revising the heading of paragraph (b) to read "*Aggregate monthly compensation paid by two or more employers exceeds maximum taxable compensation.*"

(C) By striking "after 1946" in that part of paragraph (b) which precedes subparagraph (1) and inserting in lieu thereof "after December 31, 1946, and before July 1, 1954".

(D) By striking the parenthetical sentence appearing immediately after subparagraph (6) of paragraph (b).

(E) By adding at the end of paragraph (b) the following:

If an employee is paid compensation after December 31, 1946, by two or more employers for services rendered during any one calendar month after June 30, 1954, and if the aggregate compensation paid to such employee after December 31, 1946, by all employers for services rendered during such month is in excess of $350, the measure of the employers' tax of each employer with respect to the compensation paid by him after December 31, 1946, to the employee for the month shall be determined in accordance with the provisions of subparagraphs (1) through (6) above, except that the determination shall be made with reference to $350 rather than $300.

(For provisions relating to the circumstances under which certain compensation is to be disregarded for the purpose of determining the employers' tax, see paragraph (c) of this section.)

(F) By revising the heading of paragraph (c) to read "*Certain compensation to be disregarded.*—(1) *Nominal monthly compensation earned by employee of local lodge or division of railway-labor-organization employer.*"

(G) By adding at the end of paragraph (c) the following new subparagraph:

(2) *Compensation for service as delegate to national or international convention of railway-labor-organization employer.*—Compensation paid on and after April 1, 1954, for service as a delegate to a national or international convention of a railway-labor-organization employer shall be disregarded for the purpose of determining the employers' tax if the individual rendering such service has not previously rendered service, other than as such a delegate, which may be included in his "years of service" for purposes of the Railroad Retirement Act of 1937.

Par. 12. Immediately preceding section 411.501, the following is inserted:

SECTION 203 OF THE ACT OF AUGUST 31, 1954 (68 STAT. 1040)

Section 1510 of the Railroad Retirement Tax Act is hereby amended by inserting after the word "month" the following: "before July 1, 1954, and as is not in excess of $350 for any calendar month after June 30, 1954".

PAR. 13. Section 411.501 is amended to read as follows:

Sec. 411.501 MEASURE OF EMPLOYEE REPRESENTATIVES' TAX.—(a) *General rule.*—Except as provided in paragraph (b) of this section, the employee representatives' tax with respect to compensation paid after December 31, 1948, for services rendered after December 31, 1946, is measured by the amount of such compensation paid to an individual for services rendered as an employee representative, excluding, however, the amount of compensation in excess of $300 which is paid after December 31, 1946, to the employee representative for services rendered during any one calendar month after December 31, 1946, and before July 1, 1954, and excluding the amount of compensation in excess of $350 which is paid after December 31, 1946, to the employee representative for services rendered during any one calendar month after June 30, 1954. (See sections 411.205 to 411.208, inclusive, relating to compensation.)

(b) *Aggregate monthly compensation as employee representative and employee exceeds maximum taxable compensation.*—(1) If during any one calendar month after December 31, 1946, and before July 1, 1954, an individual renders services as an employee representative and as an employee and the total compensation paid after December 31, 1946, to the individual for services rendered during such month as an employee representative and as an employee exceeds $300, the measure of the employee representatives' tax for such month shall be $300 minus the compensation paid after December 31, 1946, to such individual for services rendered by him during the month as an employee.

(2) If during any one calendar month after June 30, 1954, an individual renders services as an employee representative and as an employee and the total compensation paid after December 31, 1946, to the individual for services rendered during such month as an employee representative and as an employee exceeds $350, the measure of the employee representatives' tax for such month shall be $350 minus the compensation paid after December 31, 1946, to such individual for services rendered by him during the month as an employee.

(3) The application of subparagraphs (1) and (2) may be illustrated by the following example:

Example. A renders services as an employee representative during a particular calendar month before July 1, 1954, for which he is paid in the month or thereafter $100. During the same calendar month A also renders services as an employee for one or more employers and receives during the month or thereafter compensation of $275. Inasmuch as A's total compensation for services rendered during the month as an employee representative and as an employee exceeds $300 ($275 plus $100), the measure of the employee representatives' tax is $300 minus $275 (A's compensation for services rendered as an employee), or $25. (If the particular calendar month were a month after June 30, 1954, the measure of the employee representatives' tax would be $350 minus $275, or $75.)

Because this Treasury Decision merely conforms the regulations to the provisions of sections 201, 202, 203, 204, 205, and 402 of the Act of August 31, 1954 (68 Stat. 1040, 1042), and is liberalizing in nature to the extent that it gives effect to the decision in *Shattuck* v. *Gallagher* (C. A. 6th 1955) 218 F. 2d 428, it is found that it is unnecessary to issue this Treasury Decision with notice and public procedure thereon under section 4(a) of the Administrative Procedure Act, approved June 11, 1946, or subject to the effective date limitation of section 4(c) of said Act.

(This Treasury Decision is issued under the authority contained in sections 1535 and 3791 of the Internal Revenue Code of 1939 (53 Stat. 183, 467; 26 U. S. C. 1535, 3791).)

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved April 6, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Filed by the Division of the Federal Register April 10, 1956, 8:52 a. m.)

SECTION 1501.—DEDUCTION OF TAX FROM COMPENSATION

REGULATIONS 114, SECTION 411.303: Collection of, and liability for, employees' tax.

Regulations 114 amended. See T. D. 6168, page 669.

PART II.—TAX ON EMPLOYEE REPRESENTATIVES

SECTION 1510.—RATE OF TAX

REGULATIONS 114, SECTION 411.501: Measure of employee representatives' tax.

Regulations 114 amended. See T. D. 6168, page 669.

PART III.—TAX ON EMPLOYERS

SECTION 1520.—RATE OF TAX

REGULATIONS 114, SECTION 411.401: Measure of employers' tax.

Regulations 114 amended. See T. D. 6168, page 669.

PART IV.—GENERAL PROVISIONS

SECTION 1532.—DEFINITIONS

REGULATIONS 114, SECTION 411.202: Who are employers.

A controlled railway association engaged in the performance of services incidental to railroad transportation. See Rev. Rul. 56–27, page 487.

SUBCHAPTER D.—COLLECTION OF INCOME TAX AT SOURCE ON WAGES

SECTION 1621(b).—DEFINITIONS: PAYROLL PERIOD

REGULATIONS 120, SECTION 406.301: Payroll period.

Payroll period of employee who is occasionally paid at irregular intervals. See Rev. Rul. 56–272, page 498.

CHAPTER 10.—ADMISSIONS AND DUES

SUBCHAPTER A.—ADMISSIONS

SECTION 1700.—TAX

REGULATIONS 43, SECTION 101.4: Basis, rate, and computation of tax.

Applicability of the tax on admissions to an amount paid for a reserved seat or similar accommodation in addition to a general admission charge. See Rev. Rul. 56–111, page 513.

SECTION 1701.—EXEMPTIONS FROM TAX

REGULATIONS 43, SECTION 101.15: Exemptions from tax. Rev. Rul. 56–7

Dancing facilities operated and maintained by a city as part of its regular recreational program constitute facilities for physical exercise within the meaning of section 1701 (d) of the Internal Revenue Code of 1939, and charges for admission thereto are exempt from admissions tax if the proceeds therefrom inure exclusively to the city.

Advice has been requested whether dancing facilities operated and maintained by a city as part of its recreational program constitute facilities for physical exercise within the meaning of section 1701(d) of the Internal Revenue Code of 1939.

The city sponsors weekly community dances in its local civic auditorium for the purpose of providing a wholesome environment for dancing for its young people. The dances are supervised by officers appointed by the city officials and are supported, in part, by the taxpayers of the city. Charges for admission to the dances are held to a minimum in order to encourage the young people to attend. All proceeds from such affairs inure exclusively to the city.

Under the provisions of section 1701 (d) of the Code no tax attaches to any admission to swimming pools, bathing beaches, skating rinks, or other places providing facilities for physical exercise, operated by any State or political subdivision thereof or by the United States or any agency or instrumentality thereof if the proceeds therefrom inure exclusively to the benefit of the State, political subdivision, United States, agency, or instrumentality.

Senate Report No. 781, Eighty-second Congress, C. B. 1951–2, 458, at 538, indicates that Congress intended to limit the benefit of section 1701 (d) of the Code to activities which are appropriate for the Government to encourage, especially if those activities are Government supported. Further, the Report states, at page 592, that the exemption provided by section 1701 (d) of the Code is intended to apply to "admissions to facilities for physical recreation."

In view of the provisions of law and the expressions of intent found in the Senate Report concerning the exemption provided by section 1701 (d) of the Code, it is held that dancing facilities operated and maintained by a city as a part of its recreational program for the purpose and in the manner described above constitute facilities for

physical exercise within the meaning of section 1701 (d) of the Code, and charges for admission thereto are exempt from admissions tax if the proceeds therefrom inure exclusively to the city.

Rev. Rul. 56–178

The exemption provided by section 1701(b) of the Internal Revenue Code of 1939 does not apply to charges made for seating accommodations to witness grandstand events at an agricultural fair, such as rodeos or races, where free standing room accommodations are provided for a comparatively limited number of persons who secure only a limited view of the events.

Revenue Ruling 161, C. B., 1953–2, 334, amplified.

Advice has been requested whether the exemption provided by section 1701(b) of the Internal Revenue Code of 1939, with respect to admissions to agricultural fairs, applies to charges made for grandstand accommodations under the circumstances described below.

In the instant case, a nonprofit agricultural fair association makes no charge for admission to the fair which it conducts. The only revenue producing events conducted by it are rodeos and automobile races to which grandstand admissions are sold. The association provides free standing room accommodations for a comparatively limited number of persons. Such accommodations afford standees only a limited view of the events.

Section 1701(b) of the Code provides that the tax imposed on admissions by section 1700(a) of the Code shall not apply to any admissions to agricultural fairs, if no part of the net earnings thereof inures to the benefit of any stockholder or member of the association conducting the fair and if the proceeds therefrom are used exclusively for the improvement, maintenance, and operation of such agricultural fairs.

Revenue Ruling 161, C. B. 1953–2, 334, holds that the exemption provided by section 1701(b) of the Code applies to a separate charge, made in addition to the general admission charge, for admission to grandstand events which qualify in their own right as agricultural fairs. It holds further that if all persons who have paid the general admission charge may view grandstand events which do not qualify in their own right as agricultural fairs, such as rodeos or races, without payment of an additional charge, any additional payment for seating accommodations (*e. g.* grandstand seats) provided in connection with the free events is considered an extension of the general admission charge to the fair and is exempt from tax under section 1701(b) of the Code.

The basis for the exemption in the foregoing ruling, with respect to the charge for grandstand accommodations to view events which do not qualify in their own right as agricultural fairs, is that all persons having paid the general admission charge are permitted to view the events without payment of any additional charge.

It is held that since the association in the present case provides free standing room accommodations for a comparatively limited number of persons who secure only a limited view of the event, the charge made for a grandstand seat constitutes, in effect, a charge for admission to the event. Accordingly, charges made for such admissions are subject to the tax imposed by section 1700(a) of the Code. Revenue Ruling 161, *supra*, is hereby amplified.

Rev. Rul. 56–197

As a clarification of Revenue Rulings 245 and 246, C. B. 1953–2, 337 and 338, respectively, it is held that the term "concerts" as used in section 1701(c) of the Internal Revenue Code of 1939 includes ballet and classical dance performances which require musical accompaniment.

Taxability of charges for admission to homes and gardens which are not of a historical nature. See Rev. Rul. 56–190, page 517.

CHAPTER 11.—DOCUMENTS, OTHER INSTRUMENTS, AND PLAYING CARDS

SUBCHAPTER A.—RATE AND PAYMENT OF TAX

SECTION 1801.—CORPORATE SECURITIES

REGULATIONS 71, SECTION 113.55: Issues subject to tax. Ct. D. 1792

STAMP TAXES—INTERNAL REVENUE CODE OF 1939—DECISION OF SUPREME COURT

1. CORPORATE SECURITIES—PROMISSORY NOTES—DEBENTURES—CERTIFICATES OF INDEBTEDNESS.

Corporation's nonnegotiable 3¼ percent promissiory notes evidencing a $4,000,000 loan from two insurance companies, maturing over a fifteen year period, containing no interest coupons, not engraved or issued in registered form, and executed simultaneously with loan agreements imposing restrictions upon the corporation for the lenders' protection, are not subject to the documentary stamp tax on "debentures" or "certificates of indebtedness." The unexercised provision in the underlying loan agreements for substitution of instruments that might qualify as debentures does not render them taxable, for until debentures are in existence the "debenture" tax cannot be imposed.

2. DECISION AFFIRMED.

Decision of the United States Court of Appeals for the Ninth Circuit, 218 F. 2d 91, affirmed.

SUPREME COURT OF THE UNITED STATES

United States of America, petitioner, v. Leslie Salt Co.

On writ of certiorari to the United States Court of Appeals for the Ninth Circuit

[March 5, 1956]

OPINION

Mr. Justice HARLAN delivered the opinion of the Court.

On February 1, 1949, Leslie Salt Company, being in need of funds to meet maturing bank loans and for working capital, borrowed $3,000,000 from the Mutual Life Insurance Company of New York and $1,000,000 from the Pacific Mutual Life Insurance Company. As evidence of the indebtedness Leslie Salt delivered to each insurance company its "3¼ percent Sinking Fund Promissory Note Due February 1, 1964" in these amounts. The question presented is whether these instruments are subject to the documentary stamp taxes laid on "all bonds,

debentures, or certificates of indebtedness issued by any corporation * * *" under sections 1800 and 1801 of the Internal Revenue Code of 1939.[1]

The Commissioner of Internal Revenue held the tax applicable, considering the two instruments to be "debentures" within the meaning of section 1801. However, in a tax recovery suit instituted by Leslie Salt, following payment of the tax under protest and the Commissioner's denial of a refund, the District Court[2] and the Court of Appeals[3] held the instruments not to be "debentures" or otherwise subject to stamp taxes. We brought the case here, 349 U. S. 951, to resolve the uncertainty left by lower court decisions as to whether section 1801 applies to corporate notes of this type.[4]

Except as to amounts and payees, the two instruments in question were in identical terms, having these principal features: (1) each instrument carried the promissory note description already indicated; (2) each had a maturity of 15 years; (3) each carried interest of 3¼ percent payable August 1 and February 1 of each year on the unpaid balance; and (4) each was subject to the terms of an underlying agreement containing elaborate provisions for the protection of the note holders. Among those provisions was one under which each insurance company could require Leslie Salt to convert its note, which was typewritten on ordinary white paper, into a series of new notes in denominations of $1,000 or multiples thereof, "either in registered form without coupons or in coupon form, and in printed or in fully engraved form."[5] This option has not been exercised by either note holder.

These transactions with the two insurance companies constituted a variety of "private placement," a method of corporate financing which, because of its economies and conveniences, has become popular since the enactment of the Securities Act of 1933. The Government claims that these notes are taxable under section 1801 either as "debentures" or "ceritficates of indebtedness." The tax-

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[1] SEC. 1800. "There shall be levied, collected, and paid, for and in respect of the several bonds, debentures, or certificates of stock and of indebtedness, and other documents, instruments, matters, and things mentioned and described in sections 1801 to 1807, inclusive, or for or in respect of the vellum, parchment, or paper upon which such instruments, matters, or things, or any of them, are written or printed, the several taxes specified in such sections."

SEC. 1801. "On all bonds, debentures, or certificates of indebtedness issued by any corporation, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities, on each $100 of face value or fraction thereof, 11 cents: *Provided*, That every renewal of the foregoing shall be taxed as a new issue * * *."

[2] 110 F. Supp. 680.

[3] 218 F. 2d 91.

[4] Decisions in the Courts of Appeals pointing toward the taxpayer's view are *Curtis Publishing Co.* v. *Smith*, 220 F. 2d 748 (C. A. 3d Cir.); *Niles-Bement-Pond Co.* v. *Fitzpatrick*, 213 F. 2d 305 (C. A. 2d Cir.); *United States* v. *Ely and Walker Dry Goods Co.*, 201 F. 2d 584 (C. A. 8th Cir.); *Allen* v. *Atlanta Metallic Casket Co.*, 197 F. 2d 460 (C. A. 5th Cir.); *Belden Mfg. C.* v. *Jarecki*, 192 F. 2d 211 (C. A. 7th Cir.), and in the District Courts are *Bijou Theatrical Enterprise Co.* v. *Menninger*, 127 F. Supp. 16 (D. C. E. D. Mich.); *Knudson Creamery Co. of California* v. *United States*, 121 F. Supp. 860 (D. C. S. D. Calif.); *Shamrock Oil & Gas Co.* v. *Campbell*, 107 F. Supp. 764 (D. C. N. D. Tex.); *Follansbee Steel Corp.* v. *United States*, 4 P–H 1955 Fed. Tax Serv. ¶72,715 (D. C. W. D. Pa.); *United Air Lines Inc.* v. *United States*, 4 P–H 1955 Fed. Tax Serv. ¶72,567 (D. C. N. D. Ill.); *Motor Finance Corp.* v. *United States*, 4 P–H 1954 Fed. Tax Serv. ¶72,706 (D. C. D. N. J.). Decisions in the Court of Appeals pointing the other way are *General Motors Acceptance Corp.* v. *Higgins*, 161 F. 2d 593 (C. A. 2d Cir.), [Ct. D. 1708, C. B. 1948–2 1571], and *Commercial Credit Co.* v. *Hofferbert*, 188 F. 2d 574 (C. A. 4th Cir.), and in the District Courts are *S. S. Pierce Co.* v. *United States*, 127 F. Supp. 396 (D. C. D. Mass.); *H. Kobacker & Sons Co.* v. *United States*, 124 F. Supp. 211 (D. C. N. D. Ohio); *General Motors Acceptance Corp.* v. *Higgins*, 120 F. Supp. 737 (D. C. S. D. N. Y.); *United States* v. *General Shoe Corp.*, 117 F. Supp. 668 (D. C. M. D. Tenn.); *Gamble-Skogmo, Inc.* v. *Kelm*, 112 F. Supp. 872 (D. C. Minn.); *Sharon Steel Corp.* v. *United States*, 4 P–H 1955 ed. Tax Serv. ¶72,716 (D. C. W. D. Pa.); and *Stuyvesant Town Corp.* v. *United States*, 111 F. Supp. 243 (Ct. Cl.).

[5] Other provisions of these agreements may be summarized as follows: (1) The basic terms under which the insurance companies agreed to "purchase" the Leslie Salt notes. (2) Representations by Leslie Salt that financial statements and lists of property holdings submitted by it were complete and accurate. (3) Various conditions precedent to the purchase of the notes, including: opinion by counsel that the transaction was authorized under the applicable state law; that the balance of the $4,000,000 loan was subscribed; and that the loan documents would be in form satisfactory to counsel. (4) A representation by the lender that it was not acquiring the note for the purpose of sale. (5) A provision for prepayment by Leslie Salt of $285,000 principal amount for each year, without premium, and of an additional $285,000 annually at the option of Leslie Salt, also without premium, as long as the prepayment came from earnings or liquidation of assets. Leslie Salt had the right to make further prepayments, but subject to a premium of 3 percent, which after the first three years of the note descended in amount at the rate of ¼ percent each year. (6) Leslie Salt promised to pay all its taxes, keep its property in repair, keep accurate records, insure its properties, and make regular financial statements to the holders of the notes. (7) Leslie Salt promised not to become indebted, not to pay dividends or retire stock, except as provided in the agreement; and not to change the nature of its business or let its working capital decline beneath a specified amount.

payer, on the other hand, contends that these terms, undefined in the statute, do not include notes of the type here in issue. Taken in light of the legislative and administrative history of the statute, we agree with the taxpayer's contention.

"Debentures" and "certificates of indebtedness," along with other kinds of corporate securities, have been subject to stamp taxes since 1898, except for the period between 1902 and 1914.[6] "Promissory notes" were also subject to stamp duties from 1898 to 1901 and from 1914 until 1924, when the tax was repealed;[7] it has never been re-enacted. The tax on "promissory notes," however, was always carried in a section separate from that containing the tax on "bonds, debentures, or certificates of indebtedness," and was always at a rate lower than the tax on those instruments. Since promissory notes, debentures, and certificates of indebtedness all serve the same basic purpose—that is, as evidence of a debt—this former legislative distinction between promissory notes and the other instruments assumes significance in determining whether the present notes are taxable. For unless the earlier statutes were intended to impose two taxes on the same instrument, which we should not assume, or the present tax on debentures and certificates of indebtedness is broader in scope than that in effect in 1924, of which there is no indication, it would seem to follow that these notes should not now be taxed if they can be said to fall within the class of "promissory notes" on which the tax was repealed.

The Government argues that the repealed promissory note provision related only to ordinary short-term paper customarily used in day-to-day commercial transactions, and that it did not embrace notes, like those here involved, of large amounts, long maturity, and secured by an elaborate underlying agreement. See *General Motors Acceptance Corp.* v. *Higgins*, 161 F. 2d 593, 595 [Ct. D. 1708, C. B. 1948–2, 157]. The existence of these features, however, does not render either of the Leslie Salt instruments any the less a promissory note, as each was captioned. Nor do we find anything in the earlier legislation or in its history which satisfies us that this type of note would not have been taxable at the lower rate provided in the promissory note section of the former statute. See *Niles-Bement-Pond Co.* v. *Fitzpatrick*, 213 F. 2d 305, 308–310. Moreover, the administrative interpretations of the Treasury, discussed below, affirmatively indicate that they would have been considered taxable under that section.

But even assuming that these notes could not fairly be called "promissory notes," it does not follow that they must therefore be regarded as "debentures" or "certificates of indebtedness." That depends upon the meaning of those terms in the statute, and upon whether these notes, regardless of their descriptive caption, have the essential characteristics of "debentures" or "certificates of indebtedness," as those terms are used in the statute. *General Motors Acceptance Corp.* v. *Higgins, supra; Niles-Bement-Pond Co.* v. *Fitzpatrick, supra.* And in determining the scope of the statute, which has remained substantially unchanged since its first enactment, the Treasury's interpretations of it are entitled to great weight. *White* v. *Winchester Club*, 315 U. S. 32, 41 [Ct. D. 1538, C. B. 1942–1, 272].

The administrative history of the statute establishes that until 1947, when the *General Motors* case, *supra*, was decided, only those instruments were considered subject to the "debenture" tax which were issued (1) in series, (2) under a trust indenture, and (3) in registered form or with coupons attached. In other words, that tax was considered to apply only to marketable corporate securities, as that term is generally understood. Conversely, corporate promissory notes lacking any of those features, such as those issued by respondent, were taxed at the lower promissory note rate until that tax was repealed in 1924, and were not taxed thereafter until the Government's success in the *General Motors* case in 1947.

As early as 1918 the Treasury, in distinguishing instruments taxable at the "bond" and "debenture" rate from those taxable at the lower "promissory note" rate, then still in force, drew the line as follows:

> "(3) Instruments containing the essential features of a promissory note, but issued by corporations in numbers under a trust indenture, either in registered form or with coupons attached, embodying provisions for acceleration of maturity in the event of any default by the obligor, for optional

[6] Act of June 13, 1898, 30 Stat. 448, 451, 458; Act of March 2, 1901, 31 Stat. 938, 940, 942; repealed by the Act of April 12, 1902, 32 Stat. 96, 97; re-enacted in the Act of October 22, 1914, 38 Stat. 745, 753, 759, and carried forward in subsequent Revenue Acts.

[7] Act of June 13, 1898, 30 Stat. 448, 451, 458; repealed by the Act of March 2, 1901, 31 Stat. 942; re-enacted in the Act of October 22, 1914, 38 Stat. 745, 753, 760; carried over in the Revenue Acts of 1917, 1918, and 1921, 40 Stat. 300, 319, 323; 40 Stat. 1057, 1133, 1137; 42 Stat. 227, 301, 305, and repealed by the Revenue Act of 1924, 43 Stat. 253, 352.

registration in the case of bearer bonds, for authentication by the trustee, and sometimes for redemption before maturity, or similar provisions, are bonds within the meaning of the statute, whether called bonds, debentures, or notes. However, a short-term instrument, although issued by a corporation under a trust indenture, may be regarded as a note if every instrument of such issue both (a) is payable to bearer and incapable of registration and (b) lacks interest coupons and so requires presentation upon each payment of interest." T. D. 2713, May 14, 1918, 20 Treas. Dec. Int. Rev. 358 (1918).[8] When Congress in 1918 amended the existing statute by adding the language "and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities * * *," still found in section 1801, the Treasury recognized that this was in effect an enactment of its prior restrictive interpretation.[9] The regulations which followed the repeal in 1924 of the tax on promissory notes did not purport to enlarge the scope of the tax on "bonds" or "debentures"; the Treasury adhered to the same interpretation issued under the previous statute.[10] The regulations were amended in 1941 to the less specific, but not inconsistent form under which the present notes were taxed.[11] Finally, explicit recognition that the attempt to tax notes not having the features of marketable corporate securities was a departure from prior Treasury practice is found in a ruling by the Commissioner of Internal Revenue that *General Motors* would not be applied retroactively:

"The Bureau has for a considerable period of time held that an instrument termed "note," not in registered form and issued without interest coupons, is not subject to the stamp tax upon issuance or transfer. Because of this long and uniform holding of the Bureau and the consequent reliance of corporations on these rulings, it has been concluded that, under the authority contained in section 3791(b) of the Internal Revenue Code, the decision in *General Motors Acceptance Corporation* v. *Higgins, supra*, will not be ap-

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[8] In the same Treasury Decision "promissory note' was defined as "An instrument not under seal containing a simple promise to pay a sum of money at a specified time, *such as is common in everyday commercial use,* is a promissory note within the meaning of the statute." It should be noted that the qualification which we have italicized was omitted from the definition of "promissory note" in the Regulation promulgated one year later. See note 10, *post.*

[9] The then Solicitor of Internal Revenue, Mr. Robert N. Miller, expressed this view:

"The words 'all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities,' were clearly added in recognition of the varied forms in which corporate securities are issued, and to defeat any attempt to avoid the tax by issuing instruments of the general character of bonds, debentures, or certificates of indebtedness under a different name." L. O. 909, Sales Tax Rulings, December, 1920 ST. 1–20–85.

[10] ART. 8. Instruments issued in numbers, under a trust indenture, are bonds.—Instruments containing the essential features of a promissory note, but issued in series, secured by a trust indenture, either in registered form or with coupons attached, embodying provisions for acceleration of maturity in the event of any default by the obligor, for optional registration in the case of bearer bonds, for authentication by the trustee, and in some instances for redemption before maturity, or similar provisions, are bonds within the meaning of the statute, whether called bonds, debentures, or notes." Treasury Regulations 55, September 13, 1924.

The regulations preceding the repeal of the tax on promissory notes provided:

"ART. 8. Instruments issued by corporations in numbers, under a trust indenture, are bonds.—Instruments containing the essential features of a promissory note, but issued by corporations in series, secured by a trust indenture, either in registered form or with coupons attached, embodying provisions for acceleration of maturity in the event of any default by the obligor, for optional registration in the case of bearer bonds, for authentication by the trustee, and in some instances for redemption before maturity, or similar provisions, are bonds within the meaning of the statute, whether called bonds, debentures, or notes.

* * * * * * * *

"ART. 48. 'Promissory note' defined.—A promissory note is an unconditional promise in writing made by one person to another signed by the maker engaging to pay on demand or at a fixed or determinable future time, a sum certain in money to such other person or to order or to bearer, free from restrictions as to registration or transfer and usually without coupons." Treasury Regulations 55, June 11, 1919.

The 1920 revision of Regulations 55 was substantially identical, as were the Regulations issued under the Revenue Act of 1921 (Regulations 55, Articles 8 and 35).

[11] SEC. 113.50. *"Scope of Tax."*—Section 1801 imposes a tax upon the issue by any corporation of bonds, debentures, certificates of indebtedness, and all instruments, however termed, with interest coupons or in registered form and known generally as corporate securities. Every renewal of the above described instruments is taxable as a new issue."

SEC. 113.55. *"Issues Subject to Tax."*—Ordinarily, a corporate instrument styled a bond, debenture, or certificate of indebtedness is subject to tax. However, the taxability of an instrument is not determined by the name alone but depends upon all the circumstances, such as the name, form, and terms of the instrument, etc. Hence, an instrument, however, designated, having all the essential characteristics of a bond, debenture, or certificate of indebtedness is taxable as such. Similarly, an instrument issued with interest coupons, or with provision for registration, and coming within the class known generally as corporate securities will be held subject to the tax regardless of the name by which it may be called."

plied retroactively, except that any tax which has been paid on the issuance or transfer of instruments falling within the scope of the decision will not be refunded." M. T. 32, Cumulative Bulletin 1948–2, page 160.

The term "certificate of indebtedness" has a similar administrative background. Since 1920 the Treasury has considered certificates of indebtedness as akin to bonds and debentures, including "only instruments having the general character of investment securities, as distinguished from instruments evidencing debts arising in ordinary transaction between individuals * * *" L. O. 909, Sales Tax Rulings, December 1920 ST: 1–20–85; Regs. 55 (Art. 14), October 26, 1920, 22 T. D. Int. Rev. 502 (1920).[12] The essence of an "investment security" is, of course, marketability, and this basic feature the Leslie Salt notes did not have. The Treasury itself has acknowledged that promissory notes lacking this quality have never been taxed as "certificates of indebtedness." M. T. 32, Cumulative Bulletin 1948–2, page 160 (*ante*, pages 8–9), and none of the lower court cases, including *General Motors*, *supra*, have regarded instruments such as the Leslie Salt notes as being certificates of indebtedness. Moreover, it may be observed that in the stamp tax sections of the Internal Revenue Code of 1954 the words "certificates of indebtedness," consistently with this administrative history, have been eliminated as a separate taxable category of corporate instruments, and is employed simply as a term of art embracing all the instruments taxed, that is, "bonds," "debentures" and other instruments in registered form or with coupons. Internal Revenue Code of 1954, sections 4311, 4381.

In contrast to the position it had consistently taken throughout the many years preceding the decision in the *General Motors* case, the Treasury now argues "that Congress intended in section 1801 to cover all long-term debt obligations supported by elaborate protective covenants and that this is so regardless of details of the papers used, the language by which the transaction was consummated or the nature of the purchaser's business." This contention seems to stem from the belief that had the "private placement" method of financing been as widely known in 1924 as it is now, Congress would not have repealed the promissory note tax in its entirety, as it did. But if that be so it is nevertheless for Congress, and not the courts, to change the statute. We must deal with the statute as we find it, and if these instruments are neither "debentures" nor "certificates of indebtedness" they may not be taxed under the present statute. These taxes are based not upon the nature of the transaction involved, but upon the character of the instruments employed. As long ago as 1873, this Court said: "The liability of an instrument to a stamp duty, as well as the amount of such duty, is determined by the form and face of the instrument, and cannot be affected by proof of facts outside of the instrument itself." *United States* v. *Isham*, 17 Wall. 496, 504.

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[12] The ruling by the Solicitor of Internal Revenue said:

"The Century Dictionary defines 'debenture' as 'A writing acknowledging a debt; specifically, an instrument, generally under seal, for the repayment of money lent; usually, if not exclusively, used as obligations of corporations or large moneyed copartnerships, issued in a form convenient to be bought and sold as investments.' This definition was adopted by the court in Barton Nat. Bank v. Atkins; 72 Vt. 55; 47 Atl. 176, 180. The term 'certificates of indebtedness' has also come to have in commercial use a similar meaning. In Denver v. Home Savings Bank, 236 U. S. 101, 105, the court said:

"'What is true about bonds is true about certificates of indebtedness. Indeed it is difficult to see any distinction between them as they are commonly known to the business world. The essence of each is that they contain a promise under seal of the corporation to pay a certain sum to order or bearer.'

"If the term 'certificates of indebtedness' standing by itself be susceptible of a broader meaning than that given to it above, its association here with bonds and debentures excludes such broader meaning. The maxim *noscitur a sociis* applies.

"A consideration of Title XI as a whole supports the conclusion above arrived at. Three classes of paper issued by individuals, partnerships, and corporations are subject thereunder to stamp tax: Bonds of indebtedness (subdivision 1), certificates of stock (subdivision 3), and drafts or checks and promissory notes (subdivision 6); i. e., instruments posessing to a greater or less extent the attributes of commercial paper.

"The premises lead inevitably to the conclusion that it was not the intention of Congress to tax under subdivision 1 of the said Schedule A every evidence of indebtedness other than those included under the heads of shares or certificates of stock, promissory notes, or bills of exchange, but only those evidences of indebtedness which have the general character of investment securities and which may properly be included under the term 'bonds of indebtedness.' The definition of 'certificate of indebtedness' as 'primarily any instrument acknowledging liability for the payment of money, not in the recognized form of a promissory note or bill of exchange,' contained in T. D. 2713, is too inclusive and does not sufficiently delimit the instruments included in the term.

"It is therefore held that the term 'certificate of indebtedness' as used in subdivision 1 of Schedule A, Title XI, Revenue Act of 1918, includes only instruments having the general character of investment securities, as distinguished from instruments evidencing debts arising in ordinary transaction between individuals; and that conditional bills of sale are not certificates of indebtedness.

"T. D. 2713 should be modified to conform with this holding.

ROBERT N. MILLER,
Solicitor of Internal Revenue."

There are persuasive reasons for construing "debentures" and "certificates of indebtedness" in accordance with the Treasury's original interpretation of those terms in this statute's altogether comparable predecessors. In *Norwegian Nitrogen Prod. Co.* v. *United States*, 288 U. S. 294, 315, Mr. Justice Cardozo said:

> "administrative practice, consistent and generally unchallenged, will not be overturned except for very cogent reasons if the scope of the command is indefinite and doubtful. *United States* v. *Moore*, 95 U. S. 760, 763; *Logan* v. *Davis*, 233 U. S. 613, 627; *Brewster* v. *Gage*, 280 U. S. 327, 336 [Ct. D. 148, C. B. IX–1, 274 (1930)]; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375 [Ct. D. 278, C. B. X–1, 424 (1931)]; *Interstate Commerce Comm.* v. *N. Y., N. H. & H. R. Co.*, 287 U. S. 178. The practice has peculiar weight when it involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new."

Against the Treasury's prior longstanding and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand. Moreover, that original interpretation has had both express and implied congressional acquiescence, through the 1918 amendment to the statute (*ante*, page 7), which has ever since continued in effect, and through Congress having let the administrative interpretation remain undisturbed for so many years. See *Corn Products Refining Co.* v. *Commissioner*, 350 U. S. 46, 53; *Norwegian Nitrogen Prod. Co.* v. *United States*, *supra*, at page 313.[13] Still further, it is an interpretation which is in accord with the generally understood meaning of the term "debentures." Cf. *First Nat. Bank* v. *Flershem*, 290 U. S. 504, 508.[14] "The words of the statute [a stamp tax statute] are to be taken in the sense in which they will be understood by that public in which they are to take effect." *United States* v. *Isham*, *supra*, at page 504.

Construing the statute as we have, we conclude that the Leslie Salt notes are neither "debentures" nor "certificates of indebtedness" within its meaning. The fact that the agreement underlying these notes provides for the substitution of instruments which might qualify as debentures does not render these notes taxable, for until debentures are in existence the "debenture" tax cannot be imposed.

We hold these notes are not subject to stamp taxes under the statute.

Affirmed.

SECTION 1802(b).—CAPITAL STOCK (AND SIMILAR INTERESTS): SALES AND TRANSFERS

REGULATIONS 71, SECTION 113.33: Sales and transfers subject to tax. Rev. Rul. 56–55

> Applicability of the documentary stamp tax to the transfer of stock pursuant to the terms of a California decedent's will where stock was acquired after July 28, 1927, and during the existence of the marital relationship.

Advice has been requested concerning the applicability of the documentary stamp tax, imposed by section 1802(b) of the Internal Rev-

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[13] It should be said that the administrative practice, which we consider as crucial here, was not brought to the attention of the Court of Appeals in *Niles-Bemont-Pond* v. *Fitzpatrick*, *supra*. Nor do *General Motors Acceptance Corp.* v. *Higgins*, *supra*, or any of the cases cited in note 4, *supra*, advert to that practice.

[14] As long ago as 1916, no less an authority in corporate finance than the late Mr. F. L. Stetson described debentures in the following terms:

"In the United States, as already mentioned, the term 'debenture' is understood to mean serial obligations of a corporation not secured by a specific mortgage, pledge or assignment of property. Of course a series of debentures may be issued without the execution of any indenture relating thereto. Prior to 1900 the few issues that had been made of such debentures were not accompanied by a trust agreement. In such case the right and privileges given to bondholders were set forth at length in the obligation, thus making a somewhat lengthy instrument. Since an issue of debentures under trust agreements by the Lake Shore R. R. Co. and by the New York Central, the custom of adopting such agreements has become general. Originally in 1893 the General Electric Company made a large issue of debentures without an agreement, but at the time of the refunding in 1912 a trust agreement was executed." "Preparation of Corporate Bonds, Mortgages, Collateral Trusts and Debenture Indentures," in Some Legal Phases of Corporate Financing, Reorganization and Regulations, page 66 (Assn. of the Bar of the City of New York, 1917).

enue Code of 1939, to the transfer of shares of stock, acquired after July 28, 1927, pursuant to the will of a decedent who had been domiciled in California, a community property state.

A California resident, who is survived by his widow, died testate in 1952 leaving his part of the community property to his heirs. Included in the corpus of the estate were shares of stock which were acquired during the existence of the marital relationship and after July 28, 1927, the effective date of section 161a of the Civil Code of California. That section provides that the respective interests of the husband and wife in community property during continuance of the marriage relationship are present, existing, and equal interests under the management and control of the husband. Section 161a gave the wife a vested interest in her one-half share of any community property acquired after July 28, 1927.

Section 1802(b) of the Code imposes a stamp tax on all sales and transfers of legal title to any shares or certificates of corporate stock.

Section 113.33 of Regulations 71 provides that transfers of stock from persons holding legal title as tenants in common to the same persons separately to effect a partition are subject to tax.

Accordingly, where a California resident dies testate leaving his part of the community property (acquired after July 28, 1927) to his heirs, the wife's undivided interest in her share of the community property is vested during coverture and is not disturbed by the death of the husband. However, the heirs, being vested immediately upon the death of the testator with the latter's undivided interest in the community property, hold their undivided interest as tenants in common with the surviving widow. The transfer of the decedent's undivided interest to his heirs is taxable and, since such interest is an undivided one in each share of stock included in the community property, the tax on the transfer is based on the entire number of shares involved. If the shares thus held by the widow and the heirs as tenants in common are divided among such persons, a further transfer tax will be incurred based on the number of shares transferred to the widow and to each of the several heirs.

See Revenue Ruling 55-686, C. B. 1955-2, 644, dealing with the transfer of stock under the will of a decedent where the stock was acquired prior to July 29, 1927.

CHAPTER 15.—TOBACCO, SNUFF, CIGARS, AND CIGARETTES

SUBCHAPTER F.—MISCELLANEOUS PROVISIONS

SECTION 2198.—REDEMPTION OF STAMPS ON PACKAGES WITHDRAWN FROM MARKET

Claims filed by a manufacturer or importer of tobacco products, after expiration of the period of limitation, as a result of such tobacco products being held in custody by a United States marshal. See Rev. Rul. 56-150, page 536.

CHAPTER 19.—RETAILERS' EXCISE TAXES

SECTION 2406.—TAX-FREE SALES

REGULATIONS 51, SECTION 320.20: Sales to States or political subdivisions thereof and to the United States.

Exemption from the tax with respect to sales to a redevelopment agency. See Rev. Rul. 56–4, page 687.

CHAPTER 29.—MANUFACTURERS' EXCISE AND IMPORT TAXES

SUBCHAPTER A.—MANUFACTURERS' EXCISE TAXES

SECTION 3403.—TAX ON AUTOMOBILES, ETC.

REGULATIONS 46, SECTION 316.4: Who is a manufacturer.

Applicability of the manufacturers excise tax to the rebuilder's sale of a reassembled generator containing an armature rewound by the reassembler and to a rebuilt clutch assembly. See Rev. Rul. 56–189, page 503.

SECTION 3404.—TAX ON RADIO RECEIVING SETS, TELEVISION RECEIVING SETS, PHONOGRAPHS, PHONOGRAPH RECORDS, AND MUSICAL INSTRUMENTS

REGULATIONS 46, SECTION 316.63: Musical instruments.

Assignment to a successor of the right to file claims for refund or credit of manufacturers excise tax paid by the predecessor. See Rev. Rul. 56–3, page 685.

SUBCHAPTER C.—GENERAL ADMINISTRATIVE PROVISIONS

SECTION 3442.—TAX-FREE SALES

REGULATIONS 46, SECTION 316.24: Sales to States or political subdivisions thereof and to the United States.

Exemption from the tax with respect to sales to a redevelopment agency. See Rev. Rul. 56–4, page 687.

SECTION 3443.—CREDITS AND REFUNDS

REGULATIONS 46, SECTION 316.204: Credits and refunds. Rev. Rul. 56-3
(Also Section 3404.)

Under the provisions of section 3477 of the Revised Statutes, a voluntary assignment of a right to file a claim for credit or refund of manufacturers excise tax is not recognized.

Advice has been requested whether a successor by purchase may file claims for refund or credit of manufacturers excise tax which has been paid by a predecessor.

A company purchased the plant and manufacturing activities of another company which was engaged in manufacturing musical instruments. Many of the musical instruments on which the predecessor had paid the manufacturers excise tax were still in the hands of dealers at the time the business was purchased by the successor. Subsequently, a number of those musical instruments were sold to religious or nonprofit educational institutions. The predecessor is now engaged in other business activity and wishes to avoid, in the case of such tax-exempt sales, the necessity for reimbursing the dealers and filing claims for refund. Therefore, the predecessor executed, in favor of the successor, an assignment of its right to file any claims for refund or credit of the manufacturers excise tax paid by it on such instruments and authorized the successor to file such claims in its own name and to receive the payment or credit.

Section 3404(d) of the Internal Revenue Code of 1939 provides that musical instruments sold to religious or nonprofit educational institutions for exclusively religious or educational purposes are exempt from tax. Section 3343(a)(3)(A)(i) of the Code provides for the allowance of a credit or refund on tax-paid musical instruments sold to either of the foregoing classes of institutions exclusively for the purposes stated.

Section 3477 of the Revised Statutes 31 U. S. C. 203 provides for the general rule that all transfers and assignments made of any claim upon the United States, or any part or share thereof, or interest therein, whether absolute or conditional, and whatever may be the consideration therefor, and all powers of attorney, orders, or other authorities for receiving payment of any such claim, or of any part or share thereof, shall, with certain exceptions not here material, be absolutely null and void, unless they are freely made and executed in the presence of at least two attesting witnesses, after the allowance of such a claim, the ascertainment of the amount due and the issuing of a warrant for the payment thereof.

Despite the broad sweep of the language of section 3477 of the Revised Statutes, some exceptions to the above general rule have become well recognized. Thus, it has been held that involuntary assignments, that is, transfers by operation of law, are not within the statute. Furthermore, some types of voluntary assignments, such as transfers by will and general assignments for the benefit of creditors, have been recognized as exceptions to section 3477. Simi-

larly, the statute does not apply to a transfer resulting from a statutory merger or consolidation of two corporations.

In the instant case, the transfer of the assets was by purchase and the assignment was a voluntary act of the parties. Accordingly, it is held that, under these circumstances, only the predecessor has a right to file a claim for refund or credit of manufacturers excise tax paid by it, and that the assignment which has been executed in this case may not be recognized. Therefore, credit or refund will be allowed only to predecessor who actually paid the tax.

Rev. Rul. 56–231

Revenue Ruling 55–763, C. B. 1955–2, 657, is based upon facts which are different from those upon which the United States Court of Claims rendered a decision in the case of *General Motors Corporation, Frigidaire Division* v. *United States*, 121 Fed. Supp. 932, certiorari denied, 348 U. S. 942. Therefore, that Revenue Ruling was not intended to, and in fact does not, indicate a concurrence by the Internal Revenue Service in that decision.

The Internal Revenue Service has been asked whether Revenue Ruling 55–763, C. B. 1955–2, 657, is based upon the decision of the United States Court of Claims in the case of *General Motors Corporation, Frigidaire Division* v. *United States*, 121 Fed. Supp 932, certiorari denied, 348 U. S. 942, and is, therefore, an indication that the Service now concurs in that decision.

The question evidently is attributable to the fact that the Revenue Ruling involves a case in which defective articles are replaced within the warranty period and thus seems to be the same situation that was present in the Frigidaire case. The Service desires to stress that, notwithstanding such apparent resemblance, the situation in the Revenue Ruling is in fact different and should not be confused with that present in the Frigidaire case.

In the Frigidaire case, the court held, in substance, that the expense of the manufacturer in fulfilling its warranty on a taxable item is in effect an "allowance" given the ultimate purchaser, that is, a readjustment of the price paid for the refrigerator, for which "allowance" a credit or refund of the tax paid with respect to the refrigerator is authorized by law. However, the manufacturer in fulfilling its warranty did not reduce the price collected from the buyers of its refrigerators.

In the situation described in Revenue Ruling 55–763, the tube manufacturer actually gave the television set manufacturer a rebate or credit against the price of the tubes which the latter had purchased for resale as replacement tubes. This credit or rebate constituted an adjustment of the selling price within the purview of section 3443(a)(2) of the Internal Revenue Code of 1939 and entitled the tube manufacturer to a refund or credit of the tax paid on these replacement tubes. Although the price readjustment was given by the tube manufacturer because of warranty considerations, the reason for the price readjustment is immaterial for tax purposes. Such tax refund or credit would be allowable for any adjustment in the selling price of the tax-paid replacement tubes.

Accordingly, the Service states that Revenue Ruling 55–763 is not based upon the decision rendered in the Frigidaire case and was not intended to, and in fact does not, indicate a concurrence by the Service in that decision.

SECTION 3444.—USE BY MANUFACTURER, PRODUCER, OR IMPORTER

REGULATIONS 46, SECTION 316.7: Tax on use by manufacturer, producer, or importer.

Applicability of the manufacturers excise tax to the rebuilder's sale of a reassembled generator containing an armature rewound by the reassembler and to a rebuilt clutch assembly. See Rev. Rul. 56–189, page 503.

CHAPTER 30.—TRANSPORTATION AND COMMUNICATION

SUBCHAPTER B.—TELEGRAPH, TELEPHONE, RADIO, AND CABLE FACILITIES

SECTION 3465.—IMPOSITION AND RATE OF TAX

REGULATIONS 42, SECTION 130.38: Rate and application of tax.

Application of the tax on communications to amounts paid for the lease of wire and equipment utilized for the closed-circuit television transmission of events or activities for private screen for limited audiences. See Rev. Rul. 56–90, page 520.

SUBCHAPTER C.—TRANSPORTATION OF PERSONS

SECTION 3469.—TAX ON TRANSPORTATION OF PERSONS, ETC.

REGULATIONS 42, SECTION 130.61: Transportation and facilities furnished to the United States, to States, or political subdivisions thereof. Rev. Rul. 56–4

(Also Sections 2406 and 3442; Regulations 51, Section 320.20, and Regulations 46, Section 316.24.)

A redevelopment agency, which is an instrumentality of a political subdivision of a state, is entitled to (1) exemption from the tax on the transportation of persons on amounts paid for transportation and facilities furnished to the agency, and (2) exemption from manufacturers and retailers excise taxes with respect to taxable articles sold to the agency, even though its funds are furnished by the Federal Government.

Advice has been requested whether a redevelopment agency, which is an instrumentality of a political subdivision of a state, is entitled to (1) exemption from the tax on the transportation of persons on amounts paid for transportation and facilities furnished to the agency and (2) exemption from the manufacturers and retailers excise taxes with respect to taxable articles sold to the agency, where its funds are furnished by the Federal Government.

A redevelopment agency, which pursuant to state law is an instrumentality of the municipality creating it, is permitted under the provisions of the Housing Act of 1949, as amended, 68 Stat. 624, 42 U. S. C. 1452, 1453, to borrow money from the Federal Government to conduct certain surveys and make certain plans in connection with the redevelopment program of the agency. This program consists of three general phases, namely, the preliminary planning stage, the final planning stage, and the loan and grant stage. At any time during the preliminary or final planning stage, the redevelopment agency has the right, on behalf of the municipality, to terminate its program without committing the municipality to any financial responsibility for the repayment of money advanced during such stages. However, once the agency enters into the loan and grant stage, which is actually the termination stage of the program, the municipality is responsible for the repayment of one-third of the amount of all funds advanced by the Federal Government to the redevelopment agency during all three stages, plus accrued interest.

Section 3469(f)(1) of the Internal Revenue Code of 1939 provides that the tax on the transportation of persons shall not apply to the payment for transportation or facilities furnished to any State, Territory of the United States, or political subdivision thereof, or the District of Columbia.

Sections 3442(3) and 2406(a) of the Code allow exemptions from the Federal manufacturers and retailers excise taxes in the case of articles and products sold for the exclusive use of any State, Territory of the United States, or any political subdivision of the foregoing, or the District of Columbia.

It is held that, since the redevelopment agency is an instrumentality of a political subdivision of the state, the exemptions from Federal excise taxes provided (1) with respect to taxable transportation and facilities furnished to a state or political subdivision thereof and (2) with respect to taxable articles sold to a state or political subdivision thereof are applicable where taxable transportation or facilities are furnished to such a redevelopment agency and where taxable articles are sold to the agency for its exclusive use, provided the requirements of the law and applicable regulations with respect to the particular exemption are met. The exemptions apply even though the purchase of the taxable transportation or facilities or the purchase of the taxable articles is made by the agency from funds furnished to it by the Federal Government during the preliminary or final planning stage of its redevelopment program, and even though the agency does not enter into the loan and grant stage of such program.

SUBCHAPTER E.—TRANSPORTATION OF PROPERTY

SECTION 3475.—TRANSPORTATION OF PROPERTY

REGULATIONS 113, SECTION 143.1: Meaning of terms.

Applicability of the tax on the transportation of property to charges made by a carrier to a customer, pursuant to an average demurrage agreement, for demurrage on cars of coal and other commodities. See Rev. Rul. 56-16, page 524.

Payments to a carrier in connection with grain doors or doorway barricades installed on box cars used for the transportation of grain. See Rev. Rul. 56-62, page 525.

REGULATIONS 113, SECTION 143.24: States, Territories, etc. Rev. Rul. 56-122

A bill of lading on which a shipment destined for a state or political subdivision thereof moves, cannot be accepted by the carrier as proof of exemption from the tax on the transportation of property, where the bill of lading shows the property is consigned to the order of the shipper, with a statement to notify the particular state or subdivision to which it is destined.

Advice has been requested whether the shipping papers described below may be accepted by a carrier as proof that a shipment destined for a state or political subdivision thereof is in fact being transported to such state or subdivision, and the charges for transportation are therefore exempt from tax.

A manufacturer sells large quantities of his products to states and political subdivisions thereof. Under the terms of the sale, the purchaser is required to pay for the goods upon delivery. To guarantee payment at the time of delivery the goods when shipped to the purchaser move on an order bill of lading showing them consigned to the order of the manufacturer and containing a statement to notify the particular state or subdivision for whom they are intended. A sight draft drawn upon the purchaser is attached to the bill of lading. When the shipment arrives at the point of destination, the bill of lading is properly endorsed and forwarded to a bank which delivers it to the purchaser upon payment of the sight draft. The transportation charges are paid to the carrier by the shipper.

Section 3475(a) of the Code imposes a tax upon the amount paid for transportation of property from one point in the United States to another. The tax is payable by the person making the taxable transportation payment and is collectible by the person receiving such payment.

Section 3475(b) of the Code provides for exemption from tax of amounts paid for transportation of property to or from a State, Territory, or political subdivision thereof, or the District of Columbia.

Under the provisions of section 143.24 of Regulations 113, where the shipping papers show the consignor or consignee to be a State, Territory, or political subdivision thereof or the District of Columbia, or any agency or instrumentality of any of the foregoing, such papers may be accepted by the carrier as proof of the exempt character of the shipment.

Since the person receiving a payment for taxable transportation is the person required to collect the tax and pay it over to the Government, such person must be in a position to readily determine at the time the transportation charges are paid whether the charges come within an exempt category or whether the tax should be collected.

Therefore, where a shipper claims exemption from the payment of the tax on the basis that the shipment is being transported to a state or political subdivision thereof, the responsibility rests upon the shipper to consign the shipment in such a manner that the shipping papers clearly show that the consignee is a state or political subdivision thereof, in order that the carrier may accept such papers as proof of the exempt character of the shipment.

It is held that where a shipment destined for a state or political subdivision thereof moves on an order bill of lading, which shows the property consigned to the order of the shipper and contains a statement to notify the particular state or subdivision thereof for which the property is intended, such shipping papers do not constitute sufficient evidence that the property is in fact being transported to the state or political subdivision within the meaning of section 3475(b) of the Code, and cannot be accepted by the carrier as proof of the exempt character of the shipment. Accordingly, in such a case where the transportation charges are paid by the shipper, the tax is properly collectible from the shipper by the carrier. No exemption certificate has been prescribed or may be accepted by the carrier in lieu of the tax.

However, where a shipper has paid the transportation charges and tax to the carrier with respect to a shipment made pursuant to a purchase order issued by a state or political subdivision thereof, and such shipment was actually delivered to the state or political subdivision, even though the shipping papers did not show that the shipment was consigned directly thereto, the shipper may file Form 843, Claim, for refund of the tax paid with the District Director of Internal Revenue for the district in which is located the shipper's principal place of business. There should be attached to the claim (1) the original receipts issued by the carrier showing payment of the tax involved, (2) a copy of the purchase order issued by the state or political subdivision thereof, pursuant to which the property was shipped from the place of origin, and (3) documentary evidence sufficient to establish that the shipment was actually delivered to the state or political subdivision thereof.

REGULATIONS 113, SECTION 143.30: Transportation of property beyond the boundaries of the United States. Rev. Rul. 56-219

Where grain purchased by a company is shipped to its elevator and the determination whether the grain is to be reshipped for export or for domestic use is not made until after the grain has been placed in the company's elevator, the movement of the grain from the point of origin to the elevator is domestic in character and subject to tax on the transportation of property.

Advice has been requested whether the tax on the transportation of property, imposed by section 3475 of the Internal Revenue Code of 1939, applies to amounts paid for the transportation of grain under the circumstances described below.

In the instant case, the company purchases grain from farmers for delivery to its elevator located at an interior point. The company has export orders antedating the delivery of grain to the carriers at points of origin and the grades of grain specified in the orders are grades common for either export or domestic use. At the time the grain is delivered to carriers at the points of origin, it is not known by the shippers or by the company which shipments are to be exported. The shipments when received by the company are commingled and stored in its elevator with other grain awaiting shipment for export and for domestic use. The majority of the grain in the elevator is used to fill domestic orders.

Section 3475 of the Code imposes a tax upon the amount paid for the transportation of property by rail, motor vehicle, water or air from one point in the United States to another. In accordance with Subpart E of Regulations 113, the tax does not apply to an amount paid for the transportation of property in the course of exportation to a foreign destination, or shipment to a possession of the United States. Exportation does not begin until (a) a definite intention to export property is formed and (b) the property is actually put into motion for a foreign destination, or is delivered to a carrier for such transportation. Property is not considered to be in the course of exportation when it is being assembled for shipment, or is being moved to a place to be shipped, if a foreign destination is undetermined and the property has not been actually and definitely started for some foreign destination. Reshipment for export of a domestic shipment does not change the domestic shipment to foreign commerce.

Section 143.30 of Regulations 113 provides that property will be considered to be in the course of exportation from the time of delivery to a carrier in the United States for transportation by continuous movement to a point beyond the boundaries of the United States. The export character of a shipment shall be evidenced by a contract, order, proposal of purchase or other written evidence of the intention to export, antedating the delivery of the shipment to the carrier.

In view of the foregoing, in order for a shipment of grain to an elevator to be considered as being in the course of exportation, it must be shown (1) that prior to commencement of the movement, the shipper had in his possession (a) a contract or order calling for delivery of the grain beyond the boundaries of the United States or, (b) if the shipper is not the actual exporter, written evidence that the exporter had such a contract or order, and (2) that subsequently there was delivered at a point or points of origin in the United States the quantity and quality

of grain covered by the contract, or order, to be transported by a continuous movement to the destination beyond the boundaries of the United States.

It is held that since, under the circumstances described above, the grain is not purchased by the grain company specifically to fill the export orders held by it and the determination of whether the grain is to be reshipped for export is not made until after the grain has been placed in the company's elevator, the grain when delivered by the shippers to a carrier had not actually and definitely started for some foreign destination and is not in the course of exportation. Therefore, the movement of the grain from the points of origin to the grain company's elevator is domestic in character and amounts paid for such transportation are subject to tax on the transportation of property imposed by section 3475 of the Code.

Applicability of the transportation of property tax to the delivery by a truck owner to his customers of commodities purchased by him where his sole remuneration is based on a charge for transportation. See Rev. Rul. 56–218, page 527.

REGULATIONS 113, SECTION 143.31: Continuity of movement.

The stoppage of an export shipment of grain for inspection by Federal officials for the purpose of determining its grade and character. See Rev. Rul. 56–229, page 528.

CHAPTER 34.—INFORMATION AND RETURNS

SUBCHAPTER B.—DETERMINATION OF TAX LIABILITY

SECTION 3612(d).—RETURNS EXECUTED BY COMMISSIONER OR COLLECTOR: ADDITIONS TO TAX

REGULATIONS 128, SECTION 408.909: Additions to tax for delinquent or false returns.

The assessment of a delinquency penalty where assignee fails to file timely return. See Rev. Rul. 56–168, page 596.

SECTION 3616.—PENALTIES

Jury instruction where the facts necessary to prove both a felony and misdemeanor are identical. See Ct. D. 1797, page 644.

CHAPTER 36.—COLLECTION

SUBCHAPTER B.—LIEN FOR TAXES

SECTION 3672.—VALIDITY AGAINST MORTGAGEES, PLEDGEES, PURCHASERS, AND JUDGMENT CREDITORS

Ct. D. 1789

FEDERAL TAXES—INTERNAL REVENUE CODE OF 1939—DECISION OF COURT

1. FEDERAL TAX LIEN—FILING OF NOTICE—PROPERTY SUBJECT TO DISTRAINT.

A debt owing to a delinquent taxpayer is property subject to distraint and by a levy on the debtor the United States obtains possession of that property, which possession is not affected by the taxpayer's bankruptcy after the levy. The Federal and State statutes pertaining to filing notices of lien relate to tangible property and not to debts. Also, rights of the United States under its levy were not postponed to the administration and wage claims by the Bankruptcy Act.

2. JUDGMENT REVERSED.

Judgment of the United States District Court for the Southern District of West Virginia (125 F. Supp. 517) reversed.

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

United States of America, appellant, v. *Edward I. Eiland, trustee in bankruptcy of Sport Coal Company, Inc., a corporation, bankrupt, appellee*

Appeal from the United States District Court for the Southern District of West Virginia, at Charleston

Before PARKER, Chief Judge, and SOPER and DOBIE, Circuit Judges

[Argued April 21, 1955. Decided May 23, 1955.]

OPINION

PARKER, Chief Judge: This is an appeal in the bankruptcy proceedings of the Sport Coal Company, Inc., a corporation which had its office and principal place of business in Logan County, West Virginia, and which was adjudicated a bankrupt on a voluntary petition in bankruptcy filed June 29, 1953. On June 26, 1953, before the institution of the bankruptcy proceedings, a levy was issued by the District Director of Internal Revenue on Form 668-A directed to the Boone County Coal Corporation, levying upon any indebtedness owing by the Boone County Coal Corporation to the Sport Coal Company, Inc., up to the sum of $7,172.42 and demanding that the Boone County Coal Corporation pay same to the Director from the amount so owing. The Boone County Coal Corporation, which owed the Sport Coal Company, Inc. the sum of $1,885.54 at that time, accepted service of this notice of levy and demand. After the adjudication of bankruptcy it paid this sum into the hands of the Trustee in Bankruptcy pursuant to an order of the referee. The United States claims a lien on this amount for the taxes for which its levy and demand were made upon the Boone County Coal Company.

The Referee in Bankruptcy held that the United States was not entitled to prevail against the trustee in bankruptcy with respect to its claim on this fund because no lien was filed in the office of the Clerk of the County Court of Logan County, West Virginia. He held, also, that, even if this position were not sustained, the claim of the United States should be postponed to administration and wage claims under section 67(c) of the Bankruptcy Act and that, as these exceeded the total of the assets of the bankrupt estate, the United States would not be entitled to receive anything on its claim, in any event. The District

Judge sustained the referee on the first of these holdings and found it unnecessary to pass upon the second. Two questions are presented by the appeal: (1) Did the failure to file notice in the office of the Clerk of the Court of Logan County defeat the rights of the United States under the levy and notice served upon the Boone County Coal Corporation? (2) If not, is the right of the United States under such levy and notice postponed to the administration and wage claims? We think that both of these questions should be answered in the negative.

It should be noted in the first place, that what we are dealing with here is, not a levy upon corporeal property, where the property is left in the possession of the bankrupt to serve as a basis for credit, but a levy upon an indebtedness with service of notice upon the debtor, the effect of which is to transfer to the United States the right to receive payment of the indebtedness up to the amount of the tax. A lien for taxes upon failure to pay on demand is provided for by 26 USC 3670; and this lien arises upon deposit of the assessment list with the Director, 26 USC 3671. Where taxpayer neglects or refuses to pay the taxes due, assertion of this lien is authorized by 26 USC 3692 by levy upon all property and rights to property of taxpayer except such as is specifically exempted by 26 USC 3691, which has no application here. Upon such levy, it becomes the duty of the debtor to pay the indebtedness levied upon, up to the amount of the tax, to the Director, 26 USC 3710. Levy here was made under section 3692 on form 668–A, which notified the Boone County Coal Corporation: "That all property, rights to property, moneys, credits and/or bank deposits now in your possession and belonging to the aforesaid taxpayer and all sums of money owing from you to the said taxpayer are hereby seized and levied upon for the payment of the aforesaid tax, together with penalties and interest, and demand is hereby made upon you for the amount necessary to satisfy the liability set forth above from the amount now owing from you to the said taxpayer, or for such lesser sum as you may be indebted to him, to be applied in payment of the said tax liability."

There can be no question, we think, but that the lien for taxes provided by the statute can be asserted against intangible property such as a debt. *United States* v. *Liverpool, London & Globe Ins. Co.*, 348 U. S. 215 [Ct. D. 1780, C. B. 1955–1, 549]; *Cannon* v. *Nicholas*, 10 Cir. 80 F. 2d 934 [Ct. D. 1113, C. B. XV–1, 313 (1936)]; *Kyle* v. *McGuirk*, 3 Cir. 82 F. 2d 212; *United States* v. *First Nat. Bank*, 8 Cir. 89 F. 2d 116; *McKenzie* v. *United States*, 9 Cir. 109 F. 2d 540; *United States* v. *Long Island Drug Co.*, 2 Cir. 115 F. 2d 983, 985–986; *United States* v. *Warren R. Co.*, 2 Cir. 127 F. 2d 134, 137–138; *Investment & Securities Co.* v. *United States*, 9 Cir. 140 F. 2d 894; *United States* v. *Manufacturers Trust Co.*, 2 Cir. 198 F. 2d 366; *United States* v. *Ocean Accident & Guarantee Corporation*, 76 F. Supp. 277. And we think it equally clear that the proper way to assert the lien is by levy and notice such as was served here. There is apparent holding to the contrary in such cases as *United States* v. *O'Dell*, 6 Cir. 160 F. 2d 304 and *Givan* v. *Cripe*, 7 Cir. 187 F. 2d 225, to the effect that a "warrant of distraint" is necessary in addition to the notice to the debtor; but where, as here, the Director serves notice upon the debtor stating that the money owing "is seized and levied upon" for the payment of the tax and that demand is made upon the debtor for the amount necessary to satisfy the tax, he is serving a "warrant of distraint". No peculiar virtue inheres in the name ascribed to the notice. As said in *Raffaele* v. *Granger*, 3 Cir. 196 F. 2d 620, 623: "Distraint is a summary, extra-judicial remedy having its origin in the common law. There, a form of self-help, it consisted of seizure and holding of personal property by individual action without intervention of legal process for the purpose of compelling payment of debt."

A creditor ordinarily perfects a lien upon a debt by attachment and garnishment with service of notice thereof upon the debtor. See *Miller* v. *United States* 11 Wall. 268, 297; *Kennedy* v. *Brent* 6 Cranch 187; *Rickman* v. *Rickman* 180 Mich. 224, 146 N. W. 609, Ann. Cas. 1915C 1237, 1248; *Strawberry Growers' Selling Co.* v. *Lewellyn* 158 La. 303, 103 So. 823, 39 A. L. R. 1502; 4 Am. Jur. p. 896; 5 Am. Jur. p. 94; 7 C. J. S. p. 403. When this has been properly done, the effect thereof is to give to the attaching creditor a lien upon the indebtedness for the amount necessary to satisfy the judgment rendered in the proceedings in his favor. The effect of the Federal taxing statutes to which we have referred is to create a statutory attachment and garnishment in which the service of notice provided by statute takes the place of the court process in the ordinary garnishment proceeding. There is no necessity for adjudicating the amount of

the tax under the statutory proceeding (*United States* v. *Morris & Essex R. Co.* 2 Cir. 135 F. 2d 711, cert. den. 320 U. S. 754); and, consequently, the service of such notice results in what is virtually a transfer to the government of the indebtedness, or the amount thereof necessary to pay the tax, so that payment to the government pursuant to the levy and notice is a complete defense to the debtor against any action brought against him on account of the debt. *Columbian Nat. Ins. Co.* v. *Welch* 1 Cir. 88 F. 2d 333; *United States* v. *Ocean Accident & Guarantee Corp.* 76 F. Supp. 277, 278; *United States* v. *Marine Midland Trust Co.* 46 F. Supp. 38. When bankruptcy occurs after the levy and notice have been served upon a debtor of the bankrupt, the trustee in bankruptcy cannot interfere with the rights of the United States thereby perfected before bankruptcy.

There is nothing in 26 USC 3672(a)(1) which invalidates as against a trustee in bankruptcy rights acquired under such a levy upon a debt. That section has reference to liens upon tangible personal property having a situs, not to the levy upon or the transfer of debts, as to which no recording of lien could be of any advantage to creditors. The section is as follows:

> "(a) *Invalidity of Lien Without Notice.*—Such lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the collector—
> "(1) *Under state or territorial laws.*—In the office in which the filing of such notice is authorized by the law of the State or Territory in which the property subject to the lien is situated, whenever the State or Territory has by law authorized the filing of such notice in an office within the State or Territory; or * * *."

For authorization of filing by State law reliance is placed upon West Virginia Code (1949) ch. 38 art. 10 sec. 1, which after providing for the filing of Federal tax liens in the offices of clerks of county courts provides:

> "No such tax shall be a valid lien as against any mortgagee, purchaser or judgment creditor, until such notice shall be filed in the office of the clerk of the county court of the county or counties in which the property subject to such lien is situated."

Both the Federal statute and the statute of West Virginia manifestly have reference to tangible property, which left in the possession of taxpayer may serve as a basis of credit, and as to which the taking of possession by a lien claimant is generally held equivalent to the recording of lien. *Firestone Tire & Rubber Co.* v. *Cross* 4 Cir. 17 F. 2d 417. Only tangible property can properly be said to be "situated" in a county within the meaning of the statutes quoted; and it would be unreasonable to apply their provisions to debts, since debtors could not be expected to search the clerk's office before paying a debt, to see whether or not tax liens had been filed against their creditors, nor could banks be expected to make such search before honoring checks drawn or deposits. With respect to such intangible property entirely different provisions are needed and have been made by the taxing statutes. Prior to levy and notice, the debtor may discharge his debt by payment to the creditor, whatever may have been filed in the clerk's office; thereafter it may be discharged as to the amount of the tax, only by payment to the Director, 26 USC 3710(b).

There can be no question, of course, but that a trustee in bankruptcy is vested by law with all the rights which a creditor could have obtained by legal or equitable proceedings at the time of the bankruptcy. Under the bankruptcy act of 1898, 30 Stat. 544, 565–566, as originally enacted, the trustee was vested with no greater rights in the property of the bankrupt than the bankrupt himself had, with the result that unregistered chattel mortgages and other secret liens could be asserted against the trustee after adjudication, although by adjudication creditors were prevented from attaching a lien to the property by legal process. *Bailey* v. *Baker Ice Machine Co.*, 239 U. S. 268; *Carey* v. *Donahue*, 240 U. S. 430; *Martin* v. *Commercial Bank*, 245 U. S. 513. Subsequent amendments to the bankruptcy act were designed to remedy the evils which had arisen from this situation. See House Report No. 1293, 81st Congress 2d Session; United States Congressional Service 81 Congress 2d Session vol. 2 pp. 1985–1990. The Amendment of 1952, 66 Stat. 420, 430, finally put section 70(c) in its present form providing: "The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt

could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as if such date with the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists."

The effect of the section as amended is to vest the trustee, not only with rights with respect to the bankrupt's property which creditors had acquired at the date of bankruptcy, but also with all rights which creditors might have acquired by legal or equitable process on that date; but this does not help the trustee here, since no creditor could have acquired any rights on that date with respect to a debt on which the United States had already made a levy and served a notice, the effect of which was to transfer the right to receive payment of the debt to the United States. We need not concern ourselves here with what the rights of the United States would be had there been no levy and its rights were dependent upon the inchoate lien on all property created by sections 3670 and 3672 of Title 26 of the Code. In such case, questions of a very different nature would be presented. What we have is a perfected lien created by levy with respect to a specific indebtedness. See *Goggin, Trustee* v. *Division of Labor Enforcement of California*, 336 U. S. 118 [Ct. D. 1713, C. B. 1949–1, 264]; *United States* v. *Sands*, 2 Cir. 174 F. 2d 384.

We think, also, that the rights of the United States are not postponed to administration and wage claims by section 67(c) of the Bankruptcy Act which provides:

"c. Where not enforced by sale before the filing of a petition initiating a proceeding under this Act, and except where the estate of the bankrupt is solvent: (1) though valid against the trustee under subdivision b of this section, statutory liens, including liens for taxes or debts owing to the United States or to any State or any subdivision thereof, on personal property not accompanied by possession of such property, and liens, whether statutory or not, of distress for rent shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act and such liens for wages or for rent shall be restricted in the amount of their payment to the same extent as provided for wages and rent respectively in subdivision a of section 64 of this Act. * * *."

That section also manifestly has reference to tangible property which can be taken into possession, not to indebtedness which has been levied upon with notice to the debtor so that it is to all intents and purposes assigned to the United States. *City of New York* v. *Hall* 2 Cir. 139 F. 2d 935, upon which the trustee relies, dealt with tangible property. If the statute be construed to apply to indebtedness, however, then what was done by the United States here must be construed as taking into possession within meaning of the statute. The United States had done everything that it could do to assert dominion over the indebtedness and by the levy and notice had made it impossible for the debtor to secure a discharge thereof by payment to any one other than the United States. We may say of the action taken by the United States here what was said by the Supreme Court of ordinary garnishment in *Miller* v. *United States*, *supra*, 11 Wall. 268, 279, viz: "It arrests the property in the hands of the garnishee, interferes with the owner's or creditor's control over it, subjects it to the judgment of the court (here the payment of the tax), *and therefore has the effect of a seizure*". (Italics supplied).

For the reasons stated, the judgment appealed from will be reversed and the case will be remanded with direction to enter an order that the amount received by the Trustee in Bankruptcy from the Boone County Coal Corporation be paid over to the Director of Internal Revenue.

Reversed.

Ct. D. 1790

FEDERAL TAXES—INTERNAL REVENUE CODE OF 1939—DECISION OF COURT

1. FEDERAL TAX LIEN—PRIORITY—FILING OF NOTICE.

The term "judgment creditor" as used in Section 3672 of the 1939 Code has reference only to a creditor holding a judgment obtained by judicial proceedings, and a trustee in bankruptcy does not come within that definition. Consequently, where prior to bankruptcy assessment lists were received by the Collector and demand duly

made on the taxpayer (later bankrupt) but no notice of lien was filed, the United States was entitled to priority in payment as a lienholder and not merely as a tax claimant.

2. ORDER REVERSED.

Order of the United States District Court for the Northern District of California, Southern Division (not officially reported), which confirmed order of the Referee in Bankruptcy, reversed.

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

United States of America, appellant, vs. John O. England, trustee in bankruptcy of the estate of Bradford Welch, Inc., a corporation bankrupt, appellee

Appeal from the United States District Court for the Northern District of California, Southern Division

[October 5, 1955]

OPINION

ORR, Circuit Judge: The question here for solution is the status of a claim of the United States for taxes filed in a bankruptcy proceeding. Bradford Welch, Inc., the taxpayer, was adjudicated a bankrupt on July 23, 1951. John O. England was thereafter appointed Trustee in Bankruptcy.

On April 28, 1952 the Collector of Internal Revenue filed a claim with the Trustee in Bankruptcy for withholding and insurance contributions taxes and interest thereon. An amended claim was filed August 22, 1952, claiming the sum of $2,192.64 in taxes and interest due. Of this amount the sum of $945.37 was asserted to be secured by liens on the property of Bradford Welch, Inc., by virtue of the provisions of sections 3670 and 3671 of the Internal Revenue Code of 1939[1] for the reason that on this amount assessment lists had been received by the Collector and demand duly made prior to the adjudication of bankruptcy. The Trustee objected. The Referee in Bankruptcy allowed the claim in its entirety as a priority claim, but disallowed any part thereof as a secured claim because "the United States never has filed any notice of the aforesaid claimed statutory lien as provided in section 3672 of the Internal Revenue Code." Section 3672(a) reads in part: "(a) INVALIDITY OF LIEN WITHOUT NOTICE.—Such lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the collector * * *"

On May 25, 1954, the District Court entered an order affirming the order of the referee. It is conceded that no notice was filed by the Collector under the provisions of section 3672(a) of the Revenue Act; hence, the lien of the United States was not valid against any *mortgagee, pledgee, purchaser* or *judgment creditor*. The trustee argues that he comes within the exception because he is a *judgment creditor*, constituted such by section 70(c) of the Bankruptcy Act (11 U. S. C. A. 1946 edition, supplement IV, section 110) which reads in part, "* * * the trustee * * * shall be deemed vested as of the date of bankruptcy with all the rights, remedies and powers of a creditor then holding a lien thereon by legal or equitable proceedings * * *." It is conceded by the trustee that prior to the adjudication of bankruptcy the United States held a valid tax lien in the sum of $945.37 pursuant to the provisions of sections 3670 and 3671, Internal Revenue Code, on all the property and rights to property of the bankrupt, but he denies that it had a secured claim for the reason that it had failed to file notice. The contention of the trustee that the provisions of section 70(c) of the Bankruptcy Act (11 U. S. C. A. 1946, supplement IV, section 110) establishes him a *judgment creditor* within the

[1] Internal Revenue Code of 1939:

"SEC. 3670. PROPERTY SUBJECT TO LIEN.—If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." (26 U. S. C. 1952 edition, section 3670.)

"SEC. 3671. PERIOD OF LIEN.—Unless another date is specifically fixed by law, the lien shall arise at the time the assessment list was received by the collector and shall continue until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time." (26 U. S. C. 1952 edition, section 3671.)

meaning of that term as used in section 3672 of the Revenue Act, has been resolved against him.

The Supreme Court in the case of United States v. Gilbert Associates, 345 U. S. 361, 364 [Ct. D. 1757, C. B. 1953–1, 474], has defined the term "judgment creditor" as used in said section. In that case the Court said: "Congress used the word 'judgment creditor' in section 3672 in the usual, conventional sense of a judgment of a court of record since all states have such courts." The Supreme Court in the Gilbert Associates case, *supra*, cited the concurring opinion of Justice Jackson in United States v. Security Trust and Savings Bank, 340 U. S. 47, 51–53 [Ct. D. 1736, C. B. 1950–2, 151], wherein he considered the legislative history of section 3672 and reached the conclusion, page 52, that only a judgment creditor in the conventional sense is protected.

In the Matter of Green, N. D. Ala., 124 F. Supp. 481 [Ct. D. 1776, C. B. 1955–1, 545], the Court was concerned with the identical question. It concluded that a Trustee in Bankruptcy is not a "judgment creditor" within the meaning of section 3672. See also United States v. Security Trust and Sav. Bank, *supra*, United States v. City of New Britain, 347 U. S. 81 [Ct. D. 1764, C. B. 1954–1, 277], and In Re Taylorcraft Aviation Corp., 6 Cir., 168 F. 2d 808. Hence, the term "judgment creditor" as used in section 3672 having reference only to a creditor holding a judgment obtained by judicial proceedings, the trustee does not come within the definition and, consequently, a valid tax lien in favor of the United States arose pursuant to the provisions of sections 3670 and 3671, prior to the adjudication of bankruptcy.

The order of the referee and the order of the District Court confirming are reversed insofar as said orders reject the claim of the United States to valid liens for unpaid taxes and interest in the amount of $945.37 and to priority payment under section 67 of the Bankruptcy Act.

CHAPTER 38.—MISCELLANEOUS PROVISIONS

SECTION 3797.—DEFINITIONS

REGULATIONS 118, SECTION 39.3797–1. Classification of taxables.

The classification of an association of doctors. See Rev. Rul. 56–23, page 598.

SECTION 3804(f).—TIME FOR PERFORMING CERTAIN ACTS POSTPONED BY REASON OF WAR: ADDITIONAL TIME TO BE DISREGARDED

Postponement of due date for filing and payment of taxes of individuals with Armed Forces of the United States formerly serving in the combat zone in Korea. See Rev. Rul. 56–298, page 597.

SUBPART B.—RULINGS AND DECISIONS UNDER THE FEDERAL FIREARMS ACT

Rulings and decisions published in Part II, Subpart B, of the Internal Revenue Bulletin are based on the application of provisions of the Federal Firearms Act.

SECTION 1

26 CFR 315.27: Firearm. Rev. Rul. 56–94

The Internal Revenue Service has examined and test-fired a six-shot, .22 caliber, alarm-starter revolver, designed to fire blanks which are inserted through a loading gate near the right rear side of the cylinder. The front of each chamber in the cylinder is constricted to such a degree that commercial .22 caliber fixed ammunition cannot be used; and, in addition, the breech end of the barrel is constricted while the bore is approximately ¼ inch in diameter at the muzzle. The explosion of the blank ammunition is released through a small opening in the front of the chamber and expelled from the muzzle of the barrel which is threaded on the inside so that a signal flare can be inserted and fired. By the same principle, it was found that a lead bullet, when loaded through the muzzle, could be fired to a distance of 75 feet. *Held*, any pistol or revolver ostensibly designed to fire blank ammunition but capable of expelling a projectile or projectiles by the action of an explosive is a firearm within the purview of the Federal Firearms Act, and is subject to the regulatory provisions thereof.

Rev. Rul. 56–234

A choke for a shotgun, designed to be affixed to the muzzle end of the barrel of a shotgun to control the pattern of discharge of the weapon, is a firearm subject to the requirements of the Federal Firearms Act.

The Internal Revenue Service has been requested to classify a choke, known as a "Flex-Choke," for purposes of the requirements of the Federal Firearms Act, that is, whether a person engaged in the business of manufacturing such choke must be licensed to transport, ship, or receive the device in interstate or foreign commerce.

Section 1(3) of the Federal Firearms Act, 15 U. S. C. 901(3), provides as follows:

The term "firearm" means any weapon, by whatever name known, which is designed to expel a projectile or projectiles by the action of an explosive and a firearm muffler or firearm silencer, or any part or parts of such weapon.

For the purposes of the above statute, any component, part, or appurtenance which affects the basic function of a weapon is considered in the category of a "part" thereof. Accordingly, as the choke in question is designed to be affixed to the muzzle end of the barrel of

a shotgun for the purpose of controlling the pattern of discharge from such weapon, it is a firearm within the purview of the Federal Firearms Act. A manufacturer of, or a dealer in, a shotgun choke must be properly licensed under the Act to lawfully transport, ship, or receive the device in interstate or foreign commerce and must also otherwise comply with the law and regulations.

For classification of a "Molgun" designed ostensibly to be set as a trap for small pests, see Rev. Rul. 56–28, page 552.

For an interpretation of the Federal Firearms Act with respect to the classification of guns which fire cartridges loaded with tear gas or a similar substance, see Rev. Rul. 56–29, page 552.

For classification of a device designed to fire two .38 caliber gas shells simultaneously and also to serve as a flashlight, see Rev. Rul. 56–47, page 553.

SECTION 2(a)

26 CFR 315.40: General.

Requirements for obtaining a license as a manufacturer or dealer in firearms with respect to firearms transferred in customs bond. See Rev. Rul. 56–166, page 551.

SUBPART C.—RULINGS AND DECISIONS UNDER OTHER PUBLIC LAWS

Rulings and decisions published in Part II, Subpart C, of the Internal Revenue Bulletin are based on the application of provisions of other public laws on internal revenue matters, except those relating to the various alcohol taxes, which appear in Part III.

SECTION 3 OF THE VINSON ACT, AS AMENDED

Rev. Rul. 56–282

A prime contract for the construction or manufacture of any naval vessel or any Army or Navy aircraft, or any portion thereof, entered into during a taxable year of the contractor to which the excess profits tax provided in Subchapter E of Chapter 2 of the Internal Revenue Code of 1939 is applicable, is exempt from the profit-limiting provisions of the Vinson Act. A subcontract entered into under such a prime contract is also exempt from such provisions even though such a contract was entered into in a taxable year of the subcontractor to which such excess profits tax was not applicable.
I. T. 3822, C. B. 1946–2, 186, modified.

Advice has been requested as to the effect of the decision of the Tax Court of the United States in the case of *Aluminum Company of America* v. *Commissioner*, 23 T. C. 189, on the ruling in I. T. 3822, C. B. 1946–2, 186, relating to the profit-limiting provisions (section 3) of the Vinson Act, 48 Stat. 503 at 505, 34 U. S. C. 495, as amended, with respect to contracts and/or subcontracts for naval vessels and Army or Navy aircraft, or any portion thereof, following the repeal of the excess profits tax imposed by Subchapter E of Chapter 2 of the Internal Revenue Code of 1939, as amended.

With the repeal of such excess profits tax by section 122(a) of the Revenue Act of 1945, C. B. 1945, 546, at 557, effective as to taxable years beginning after December 31, 1945, the profit-limiting provisions of the Vinson Act, *supra*, were again brought into effect. I. T. 3822, *supra*, dealt with the application of such provisions to contracts and subcontracts entered into in taxable years beginning after December 31, 1945, without differentiating between subcontracts entered into under exempt prime contracts and subcontracts entered into under prime contracts subject to the profit-limiting provisions.

In the Aluminum Company case, however, the court held that where subcontracts were entered into in the calendar year 1946 under a prime contract entered into in 1945, a taxable year to which the excess profits tax was applicable, the profit-limiting provisions of the Vinson Act did not apply to such subcontract. The court stated that the applicability of the profit-limiting provisions of the Vinson Act to a subcontract depends upon whether they apply to the prime contract. Acquiescence by the Commissioner in this decision is indicated on page 3 of this Bulletin.

Accordingly, it is held that a prime contract for the construction or manufacture of any naval vessel or any Army or Navy aircraft,

or any portion thereof, entered into during a taxable year of the contractor to which the excess profits tax provided in Subchapter E of Chapter 2 of the Internal Revenue Code of 1939 is applicable, is exempt from the profit-limiting provisions of the Vinson Act. A subcontract entered into under such a prime contract is also exempt from such provisions even though such a contract was entered into in a taxable year of the subcontractor to which such excess profits tax was not applicable.

I. T. 3822, *supra*, is hereby modified to the extent that it is inconsistent with the foregoing.

PART III

ALCOHOL TAX RULINGS AND DECISIONS

SUBPART A.—RULINGS AND DECISIONS UNDER THE INTERNATIONAL REVENUE CODE OF 1954

Rulings and decisions published in Part III, Subpart A, of the Internal Revenue Bulletin are based on the application of provisions of the Internal Revenue Code of 1954 and, unless otherwise noted therein, are published without consideration as to any application of the provisions of the Internal Revenue Code of 1939, the Federal Alcohol Administration Act, or other public laws.

SUBTITLE E.—ALCOHOL, TOBACCO AND CERTAIN OTHER EXCISE TAXES

CHAPTER 51.—DISTILLED SPIRITS, WINES, AND BEER

SUBCHAPTER A.—GALLONAGE AND OCCUPATIONAL TAXES

PART I.—GALLONAGE TAXES. SUBPART A.—DISTILLED SPIRITS

SECTION 5008.—STRIP STAMPS FOR DISTILLED SPIRITS

26 CFR 251.68: Overprinting of red strip stamps. Rev. Rul. 56–277

An importer holding a basic permit to do business under one or more trade names should have the red strip stamps overprinted with his real name and/or one of his approved trade names, consistent with the name of the importer as shown on the labels of the imported spirits to which the red strip stamps are to be applied. However, in the preparation of Form 428, Order for Bottle Stamps Other than Bottled-in-Bond Strips, Form 1627, Statement to Accompany Requisition for Red Strip Stamps for Imported Distilled Spirits, and Form 1627A, Application for Diversion of Red Strip Stamps for Imported Distilled Spirits, the importer should show his real name and the trade names under which he is authorized to do business in order that these documents may be properly related to the stamp account, Form 96, Strip Stamps Issued to and used by Importers, kept in the real name of the importer.

For the procedure for reporting of strip stamps, see Rev. Proc. 56–13, page 1037.

SECTION 5009.—STAMPS FOR DISTILLED SPIRITS WITHDRAWN FOR EXPORTATION

26 CFR 225.789: Export stamps required.

Instructions issued for the furnishing of export stamps to proprietors by storekeeper-gaugers rather than by District Directors. See Rev. Proc. 56–5, page 1021.

SECTION 5011.—ABATEMENT, REMISSION, REFUND AND ALLOWANCE FOR LOSS OR DESTRUCTION OF DISTILLED SPIRITS

26 CFR 225.497: Losses after taxpayment. Rev. Rul. 56–63

> Claims for refund of taxes paid on distilled spirits which have become lost may not be allowed in those cases where the losses occurred subsequent to the determination of the tax on the distilled spirits but prior to the physical removal thereof from the internal revenue bonded warehouse.

Advice has been requested whether a claim for refund of the tax paid on distilled spirits lost after taxpayment but prior to removal from an internal revenue bonded warehouse may be allowed.

Section 5006(a) of the Internal Revenue Code of 1954 provides in part that the internal revenue tax on distilled spirits shall be determined when the spirits are withdrawn from bond.

Section 5011, making provision for abatement, remission, refund, and allowance for loss or destruction of distilled spirits, provides in part that no tax shall be remitted or refunded where the loss occurs after the tax was determined, as provided in section 5006(a), and the spirits withdrawn from bond. Section 225.497 of Regulations relating to Internal Revenue Bonded Warehouses provides that nothing in section 5011 of the Internal Revenue Code or in such regulations shall be construed to authorize refund of the tax where the loss occurred after the tax was paid.

It is held that there is no interval between the determination of tax and the withdrawal of the distilled spirits from bond during which the spirits could be lost or destroyed. Accordingly, losses occurring after the tax has been determined or fixed are not allowable losses under section 5011 of the Code.

SUBPART B.—RECTIFICATION

SECTION 5021.—IMPOSITION AND RATE OF TAX

26 CFR 235.75: Classed as rectified liquors. Rev. Rul. 56–235

Commercial eggnog preparations made with distilled spirits and/or wine may be manufactured only by rectifiers. Such products made with distilled spirits must be packaged in liquor bottles conforming to 26 Code of Federal Regulations, Part 175, and must bear red strip stamps. Eggnog made only with wine must be packaged in containers other than indicia liquor bottles and must be labeled as wine eggnog. See Rev. Rul. 54–374, C. B. 1954–2, 457.

SUBPART C.—WINES

SECTION 5041.—IMPOSITION AND RATE OF TAX

26 CFR 251.42: Wines. Rev. Rul. 56–146

A product of Mexico, commonly known therein as "Pulque," is prepared from the fermented juice of certain species of the Agave plant. Such a product, having an alcohol content of 4.62 percent by volume and produced without the addition of any material other than sugar or water, would, upon importation into the United States, be subject to the internal revenue tax of 17 cents a wine gallon imposed on still wine in addition to the customs duty.

SECTION 5042. EXEMPTION FROM TAX

26 CFR 240.541: Limitations of exemption. Rev. Rul. 56–278

Section 5042(a)(2) of the Internal Revenue Code of 1954 permits a duly registered head of a family, subject to regulatory requirement, to produce for the use of his family an amount of wine not exceeding 200 gallons per annum, without the payment of tax. Section 240.541 of the Wine Regulations provides in part that the statutory exemption does not apply to wine made by a partnership or produced at a wine cellar by two or more heads of families jointly. *Held*, where a bonded wine cellar is operated by a partnership consisting of the members of a single family, as, for example, a bonded wine cellar operated by a partnership consisting of a husband and wife who are living together, the statutory exemption does apply to the head of such family.

SUBPART D.—BEER

SECTION 5053.—EXEMPTIONS

26 CFR 245.291: Reciprocating foreign countries.

The country of Lebanon has been added to the list of reciprocating foreign countries. See Rev. Rul. 56–81, page 746.

26 CFR 245.320: General. Rev. Rul. 56–236

Section 5053 of the Internal Revenue Code of 1954 provides that beer may be removed from the brewery, without payment of tax, for laboratory analysis, subject to such limitations and under such regulations as the Secretary or his delegate may prescribe. *Held*, beer may not be withdrawn, in metal cans or bottles, from a brewery, without payment of tax, for use in testing the glue used on the labels attached to such bottles or cans or for testing cans for leakage. Tax-paid beer only may be withdrawn for these purposes. However, under

the above provision of law and section 245.320 of the Beer Regulations, can companies may be furnished tax-free samples of beer for analysis in their laboratories in determining the effect of packaging on character and quality of the beer (*e. g.*, for pasteurization, iron pickup, and air).

SECTION 5056.—DRAWBACK OF TAX

(Also Section 5062.) Rev. Rul. 56–279

The Ryukyu Islands, including the island of Okinawa, under administrative jurisdiction of the United States as a result of the Treaty of Peace with Japan, is considered foreign territory for the purpose of exportation thereto of distilled spirits, wine or beer, without payment of tax or with benefit of drawback, under the applicable provisions of the Internal Revenue Code of 1954 and of the Regulations relating to distilled spirits, wine, and beer, issued pursuant thereto. Compare Rev. Rul. 55–6, C. B. 1955–1, 409.

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26 CFR 252.151: Authorized withdrawals. T. D. 6166[1]
(Also 252.152.)

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER E, PART 252—DRAWBACK ON LIQUORS EXPORTED

Part 252 of title 26 of the Code of Federal Regulations amended in regard to the exportation of taxpaid beer.

TREASURY DEPARTMENT,
OFFICE OF THE COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On September 23, 1955, a notice of proposed rulemaking with respect to amendment of regulations in 26 CFR (1954) part 252 was published in the Federal Register (20 F. R. 7136).

The purpose of this proposal was to effect administrative decisions (1) to permit persons other than brewers to export taxpaid beer, retaining the provision that the brewer of such beer shall file the claim for drawback of tax thereon, and (2) to simplify certain requirements governing the marking of containers. After consideration of all relevant matter presented by interested persons relating to the rules proposed, the amendments to 26 CFR (1954) part 252 set forth below are hereby adopted:

PARAGRAPH 1. Section 252.151 is amended to read as follows:

§ 252.151 AUTHORIZED WITHDRAWALS.—Taxpaid beer, brewed or produced in the United States, may be withdrawn by the owner of the beer from a brewery or any other place of storage for exportation or for use as supplies on vessels or aircraft. Claim for drawback of taxes found to have been paid may be filed only by the producing brewer or his duly authorized agent.

PAR. 2. Section 252.152 is amended as follows:

(A) By striking, in the first sentence, the words: "Entry No. ____," and, "and the port of exportation"; and

[1] 21 F. R. 1858.

(B) By striking the second sentence which begins: "The entry number assigned".

PAR. 3. The undesignated center heading preceding § 252.153 and § 252.153 are amended to read as follows:

CLAIM REQUIRED

§ 252.153 BEER EXPORTED, DEPOSITED IN FOREIGN-TRADE ZONES, OR USED AS SUPPLIES ON VESSELS OR AIRCRAFT.—Claim for allowance of drawback of internal revenue taxes on beer brewed or produced in the United States shall be prepared on Form 1582–B as required in this subpart.

PAR. 4. The undesignated center heading preceding § 252.154 and § 252.154 are amended to read as follows:

EXECUTION OF CLAIM

§ 252.154 WITHDRAWALS OF BEER BY BREWER FROM BREWERY.—When taxpaid beer is removed from a brewery for exportation, for lading as supplies on vessels or aircraft, or for deposit in a foreign-trade zone, the brewer will execute part 1 and part 3 of Form 1582–B, in triplicate. Each Form 1582–B shall be given a serial number beginning with "1" for the first day of January of each year and running consecutively thereafter to December 31, inclusive. Upon removal of the beer for shipment the brewer will immediately file one copy of Form 1582–B with the assistant regional commissioner of the region in which the producing brewery is located, and:

(a) Immediately forward the original and one copy of Form 1582–B to the collector of customs at the port of export; or,

(b) In the case of shipments to the Armed Services of the United States for export, immediately forward the original and one copy of Form 1582–B to the commanding or supply officer to whom the shipment is consigned; or,

(c) In the case of shipments to a foreign-trade zone, immediately forward the original and one copy of Form 1582–B to the customs officer in charge of the foreign-trade zone.

Where the brewer operates more than one brewery in different regions, the brewer will file the copy of Form 1582–B on which the claim for drawback is executed with the assistant regional commissioner of the region in which the principal office of the brewery is located.

PAR. 5. Immediately following § 252.154, a new § 252.154a is added, which reads as follows:

§ 252.154a REMOVALS OF BEER BY AGENT ON BEHALF OF BREWER.—Where proper power of attorney authorizing an agent to execute a claim on behalf of the brewer has been filed on Form 1534 with the assistant regional commissioner, such agent may remove taxpaid beer from the brewery where produced or from its place of storage elsewhere, and execute part 1 and part 3 of Form 1582–B on behalf of the brewer. Each Form 1582–B shall be given a serial number beginning with "1" for the first day of January of each year and running consecutively thereafter to December 31, inclusive. Such agent will prepare and dispose of Form 1582–B in accordance with the applicable procedure set forth in § 252.154.

PAR. 6. Section 252.155 is amended to read as follows:

§ 252.155 REMOVALS OF BEER BY PERSONS OTHER THAN THE BREWER OR HIS AGENT.—Where there is a removal of taxpaid beer by a person other than the brewer or the agent of the brewer for export, or for supplies on vessels or aircraft, or for deposit in a foreign-trade zone, such person shall execute part 1 of Form 1582–B, in triplicate. Where the exportation consists of the products of more than one brewer, a separate Form 1582–B must be prepared for the products of each brewer. Each Form 1582–B shall be given a serial number beginning with "1" for the first day of January of each year and running consecutively thereafter to December 31, inclusive. Information called for shall be furnished in accordance with the instructions on the form or issued in respect thereto. Upon removal of the beer for shipment such person will immediately forward one copy of Form 1582–B to the producing brewer, and:

(a) Immediately forward the original and one copy of Form 1582–B to the collector of customs at the port of export; or,

(b) In the case of shipments to the Armed Services of the United States for export, immediately forward the original and one copy of Form 1582–B to the commanding or supply officer to whom the shipment is consigned; or,

(c) In the case of shipments to a foreign-trade zones, immediately forward the original and one copy of Form 1582–B to the customs officer in charge of the foreign-trade zone. Upon receipt of the copy of Form 1582–B from the exporter, the brewer will, if he wishes to claim drawback on the beer covered thereby, execute the claim for drawback on part 3 of the form and file the claim with the assistant regional commissioner of his region. Where the claim is not filed with the assistant regional commissioner within six months after the date shown in the certificate of removal in part 1 of the form, the applicable provisions of §§ 252.166 to 252.169, relating to evidence of exportation or lading for use on vessels and aircraft shall apply.

PAR. 7. Section 252.157 is amended to read as follows:

§ 252.157 DIRECT DELIVERY FOR CUSTOMS INSPECTION; BILL OF LADING.—If the premises from which the shipment is made are located at the port of exportation, the beer shall be delivered directly for customs inspection and supervision of lading, and a copy of the export bill of lading shall be promptly forwarded to the assistant regional commissioner of the region in which the claim for drawback is filed: *Provided*, That an export bill of lading will not be required, (a) in the case of shipments to the Armed Services, where the shipment will be delivered to the commanding officer or supply officer to whom consigned, or (b) in the case of shipment for lading for use as supplies on vessels or aircraft.

PAR. 8. Section 252.158 is amended to read as follows:

§ 252.158 EXPORTATION BY VESSEL.—If the premises from which the shipment is made are located elsewhere than at the port of exportation, the beer shall be delivered either directly for customs inspection and supervision of lading, or to a carrier for transportation to the port of exportation and a copy of the export bill of lading shall be promptly forwarded to the assistant regional commissioner of the region in which the claim for drawback is filed.

PAR. 9. Section 252.159 is amended by striking from the third sentence the words "brewer or his agent" and inserting in lieu thereof the word "exporter."

PAR. 10. Section 252.162 is amended by striking from the third sentence the word "one" and inserting in lieu thereof the words "the original."

This Treasury Decision shall be effective on the first day of the first month which begins not less than 30 days following the date of publication in the FEDERAL REGISTER.

(This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U. S. C. 7805).)

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.
RALPH KELLY,
Commissioner of Customs.

Approved March 21, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Published in the FEDERAL REGISTER March 27, 1956)

26 CFR 252.152: Marks on containers.

Simplification of requirements regarding the markings on containers of beer. See T. D. 6166, page 706.

SECTION 5061.—METHOD OF COLLECTING TAX

For the procedure for reporting of distilled spirits excise tax stamps and rectification tax stamps, see Rev. Proc. 56–13, page 1037.

SUBPART E.—GENERAL PROVISIONS

SECTION 5062.—REFUND AND DRAWBACK IN CASE OF EXPORTATION

For exportation of distilled spirits and wines, free of tax or with benefit of drawback, to Okinawa, see Rev. Rul. 56–279, page 706.

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26 CFR 252.4: Reciprocating foreign countries.

The country of Lebanon has been added to the list of reciprocating foreign countries. See Rev. Rul. 56–81, page 746.

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26 CFR 252.101: Exportation through border port. Rev. Rul. 56–237

Section 5062(b) of the Internal Revenue Code of 1954 provides for a drawback equal in amount to the tax paid on distilled spirits and wines exported and authorizes the Secretary or his delegate to prescribe regulations governing the determination and payment of drawback, including the requirement of such notices, bonds, bills of lading, and other evidence of payment of tax and exportation as shall be deemed necessary. *Held*, when distilled spirits or wines, bottled or packaged especially for export with benefit of drawback, are exported to contiguous foreign territories by rail, copies of express receipts issued by a railway express agency may be accepted as evidence of exportation, provided (1) the distilled spirits or wines are adequately described thereon by showing serial numbers of the cases or packages and the quantity shipped in wine gallons, (2) such receipts are prepared in a manner to show that the shipment was sent in care of the Collector of Customs at the border port, and (3) such receipts otherwise meet the requirements with respect to bills of lading as set forth in section 252.101 of the Regulations relating to Drawback on Liquors Exported.

PART II.—OCCUPATIONAL TAX

SUBPART A.—RECTIFIER

SECTION 5083.—DEFINITION OF RECTIFIER

26 CFR 230.190: Mingling of different spirits prohibited. Rev. Rul. 56-147

(Also Section 235.697.)

Gins stored in reused cooperage for various periods may be commingled at a taxpaid bottling house or a rectifying plant for bottling without rectification, notwithstanding the difference in the periods of storage in such reused cooperage, provided they are otherwise homogeneous and the difference in color of composite samples of each batch to be commingled does not exceed two numbers on the Lovibond Tintometer, or its equivalent.

Advice has been requested whether gins produced by the same distiller at the same distillery, and under the same formula, but stored in reused cooperage for various periods, may be considered to be homogeneous for the purpose of commingling for convenience in bottling.

In Revenue Ruling 54–510, C. B. 1954–2, 562, it is held that gins stored in metal drums or paraffin lined packages may be commingled without regard to the period of storage in such containers, if otherwise homogeneous. The question here involved is whether gins stored in reused cooperage may also be commingled without regard to the period of storage.

It has been determined, in accordance with the procedures set forth in section 230.191 of the Regulations relating to the Bottling of Taxpaid Spirits, or section 235.698 of the Regulations relating to the Rectification of Spirits and Wines, that gins stored in reused cooperage, produced by the same distiller at the same distillery, and under the same formula, may be presumed to be homogeneous and eligible for commingling for bottling without rectification at a taxpaid bottling house or a rectifying plant, without regard to the period of storage of the gin in the reused cooperage, provided the difference in color of composite samples of each batch to be commingled does not exceed two color numbers on the Lovibond Tintometer, or its equivalent.

Where it is desired to commingle two or more batches of gin stored in reused cooperage, the storekeeper-gauger will take a composite sample of each batch from the dumping and reducing tank or the storage tank. The composite samples will then be forwarded by the storekeeper-gauger to the laboratory of the office of the appropriate Assistant Regional Commissioner, Alcohol and Tobacco Tax, for examination. The storekeeper-gauger will be advised of the results of the examination, and if the gins are found to be homogeneous they may be commingled and bottled without rectification pursuant to Form 230, Description and Gauge of Spirits or Wines for Bottling without Rectification. If the proprietor so desires, he may bottle the gins pending receipt of advice regarding the results of the laboratory examination, but if it is found that they are not homogeneous, the bottler will incur liability to the rectification tax by reason of such commingling.

26 CFR 235.697: Mingling of different spirits prohibited.

For commingling of gin stored in reused cooperage for bottling without rectification at a taxpaid bottling house or rectifying plant, see Rev. Rul. 56-147, page 710.

SUBPART B.—BREWER

SECTION 5091.—IMPOSITION AND RATE OF TAX

26 CFR 245.165: Special tax. (Also Part III-B, Section 3250; Regulations 18, Section 192.240.) Rev. Rul. 56-238

A qualified brewer is subject to liability for special (occupational) tax as a brewer for a fiscal year during which untaxpaid beer was stored on the brewery premises even though no beer was produced during the year.

Advice has been requested whether a brewer is liable for special tax as such as a result of having beer and brewing materials on hand during a fiscal year in which he produced no beer.

A brewer was properly qualified as such in 1934 and paid special tax as a brewer until the current fiscal year. He has produced no beer since May 1951 and has made no sales since December 1951. However, the brewer has on hand at the brewery premises a quantity of untaxpaid beer which may now be unsalable.

Section 5091 of the Internal Revenue Code of 1954 imposes a special (occupational) tax on brewers. Section 5092 thereof defines a brewer as any person who brews or produces beer for sale. Similar provisions are contained in sections 3250(c) and 3254(d) of the Internal Revenue Code of 1939.

It is held that the occupation of brewing or of producing beer means more than merely making brews. Only a brewer may possess domestically produced beer on which the tax has not been paid or determined. Accordingly, the storage of such beer is an integral element of the occupation of producing beer. Therefore, a brewer who has on hand a quantity of beer on which the tax has not been paid or determined is liable for special tax as a brewer for each fiscal year during which such beer is held even though no beer was produced during such fiscal year or years.

SUBPART C.—MANUFACTURERS OF STILLS

SECTION 5101.—IMPOSITION AND RATE OF TAX

26 CFR 196.30: Extent of changes. (Also 196.40.) Rev. Rul. 56-31

A vapor recompression device, which is attached to the base of a conventional beer still to conserve steam and which, as an incidental function, recovers and reinjects into the still the residual alcohol

contained in low boiling material, thereby preventing loss of alcohol in the stillage, is not taxable either when furnished as an integral part of a new still or when furnished separately and attached to a still already set up.

Advice has been requested whether a certain vapor recompression device is taxable under section 5101 of the Internal Revenue Code of 1954.

Section 5101 of the Code requires in part that each manufacturer of stills shall pay a special (commodity) tax of $22 for each still or worm for distilling made by him.

Section 196.40(d) of the Regulations relating to Stills provides that a separator or dephlegmator, used solely for separating vapors of lower boiling points from vapors of higher boiling points, allowing the latter to condense and reflux to the still and the former to pass forward to a worm or condenser, is not subject to the $22 tax.

The device in question, when attached to the base of a conventional beer still, acts primarily to conserve steam by recompressing the vapors from the hot stillage at the base of the still. The vapors are returned to the still for use in preheating the feed intake. An incidental function of the device is to recover and reinject into the still the residual alcohol contained in lower boiling material, thereby preventing loss of alcohol in the stillage. In effect, the device performs the function of a combination heat extractor and separator.

This vapor recompression device is analogous in principle to a dephlegmator, which is not taxable. Accordingly, the device is held not to be taxable either when furnished as an integral part of a new still or when furnished separately and attached to a still already set up.

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26 CFR 196.40: Types of distilling apparatus subject to special (commodity) tax.

For application of the special (commodity) tax on stills to a vapor recompression device attached to the base of a conventional beer still, see Rev. Rul. 56–31, page 711.

SUBPART D.—WHOLESALE DEALERS

SECTION 5114.—RECORDS

26 CFR 194.216: Records of receipt. (Also Section 194.217.) Rev. Rul. 56–95 [1]

Section 194.216 of the Regulations relating to Liquor Dealers requires that every wholesale liquor dealer shall keep a commercial record of receipts of distilled spirits, and specifies certain information which must be shown thereon. It also provides that additional information with respect to such receipts desired by the wholesale dealer may also be shown. Section 194.219 of the regulations requires, in part, that each page of the record maintained by the wholesale dealer bear a preprinted serial number. *Held*, the inclusion of items relating to products other than distilled spirits on prescribed records

[1] This Revenue Ruling has been modified by Revenue Ruling 56–351, I. R. B. 1956–30, page 102.

of receipt may be permitted, provided the additional information does not materially interfere with the intended purpose of the records (for example, if the number of such additional items does not predominate). Accordingly, applications to include wine, beer, and/or non-alcoholic items on prescribed records of receipt may be approved if such articles do not exclude distilled spirits on any sheet of the record and if the practice is not one that will defeat the purpose of prenumbering records of receipt. Any wholesale liquor dealer desiring to include items other than distilled spirits on prescribed records of receipt should make application therefor to the Assistant Regional Commissioner, Alcohol and Tobacco Tax, of the internal revenue region in which his business is conducted. Section 194.217 of the regulations, with respect to records of disposition of distilled spirits, is similarly interpreted.

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26 CFR 194.217: Records of disposition. Rev. Rul. 56–79

Wholesale liquor dealers who elect to use a modified Form 52–B, Wholesale Liquor Dealer's Monthly Report, as a record of disposition required to be maintained under section 194.217 of the Regulations relating to Liquor Dealers, may be authorized to show the serial numbers of cases of distilled spirits disposed of on the sale invoice, or other commercial record, kept in a separate file, provided proper reference is made in the modified record of disposition, Form 52–B, to such separate sales invoice file or other commercial record. The records must be maintained in such form and condition as to readily reflect the required data with respect to the physical disposition of each individual lot of distilled spirits for inspection purposes, pursuant to the applicable provisions of section 194.217 of the regulations. Authority to keep such separate records of serial numbers of cases must be secured from the appropriate Assistant Regional Commissioner, Alcohol and Tobacco Tax. In those cases where a wholesale liquor dealer has already been authorized to show serial numbers on commercial records, no new authorization is necessary, but the records must be similarly identified and the data must be readily available for inspection by internal revenue officers.

For inclusion of items other than distilled spirits in wholesale liquor dealer's records of disposition, see Rev. Rul. 56–95, above.

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26 CFR 194.220: Variations in format, or preparation, of records. Rev. Rul. 56–11

Pursuant to the provisions of section 194.220 of the Regulations relating to Liquor Dealers, as amended by Treasury Decision 6151, C. B. 1955–2, 713, the commercial records of receipt and disposition of distilled spirits prescribed by such regulations may be microfilmed if the wholesale liquor dealer establishes to the satisfaction of the Assistant Regional Commissioner, Alcohol and Tobacco Tax, a real need therefor. A viewing box or other similar device must be provided for the ready study of the microfilms by internal revenue officers.

Revenue Ruling 54–478, C. B. 1954–2, 463, is not applicable with respect to records required to be maintained on and after October 1, 1955.

Advice has been requested whether the authorization contained in Revenue Ruling 54–478, C. B. 1954–2, 463, for the microfilming of commercial records by wholesale liquor dealers may be continued upon the effective date of Treasury Decision 6151, C. B. 1955–2, 713.

Revenue Ruling 54–478, *supra*, authorized the microfilming of the commercial records maintained by wholesalers as supporting documents for Record 52, Wholesale Liquor Dealer's Record. However, the Regulations relating to Liquor Dealers, as amended by Treasury Decision 6151, *supra*, prescribe, in lieu of Record 52, the maintenance of individual records of "receipt" and "disposition" of distilled spirits. See section 194.219 of the regulations as amended. Section 194.220 provides that variations in format, or preparation, of records may be approved by the Director, Alcohol and Tobacco Tax Division, where it is shown that such variations from the prescribed requirements are necessary. In such case, it requires that a letterhead application be submitted, in triplicate, to the Assistant Regional Commissioner, Alcohol and Tobacco Tax, describing the proposed variations and setting forth the need therefor.

Accordingly, the Director, Alcohol and Tobacco Tax Division, may approve an application to microfilm commercial records of receipt and disposition of distilled spirits, provided the wholesaler applicant establishes to the satisfaction of the Assistant Regional Commissioner, Alcohol and Tobacco Tax, a real necessity for such procedure and provides a viewing box or other similar device suitable for the ready study of the microfilms by internal revenue officers.

Revenue Ruling 54–478, *supra*, is not applicable with respect to records maintained by wholesale liquor dealers covering transactions on and after October 1, 1955.

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26 CFR 230.280: Form 52–D.

For modification of information to be reported by proprietors of taxpaid bottling houses on Form 52–D, see Rev. Proc. 56–14, page 1039.

SUBPART F.—NONBEVERAGE DOMESTIC DRAWBACK CLAIMANTS

SECTION 5131.—ELIGIBILITY AND RATE OF TAX

Rev. Rul. 56–280

Section 5131 of the Internal Revenue Code of 1954 provides, in part, that distilled spirits used in the manufacture or production of medicines, medicinal preparations, food products, flavors, or flavoring extracts, which are unfit for beverage purposes, are subject to drawback. *Held*, food colors manufactured with taxpaid distilled spirits are not considered to be "food products, flavors, or flavoring extracts." Accordingly, drawback is not allowable on the distilled spirits used in the manufacture of food colors when they are sold as such. However, if the manufacturer produces food colors and uses such colors in the manufacture of food products, he may file claim for drawback on the distilled spirits which are contained in the food color at the time the color is used in the manufacture of the food product.

26 CFR 197.95: Products requiring formulas. Rev. Rul. 56-239

Section 5131 of the Internal Revenue Code of 1954 provides for the drawback of tax paid on distilled spirits used in the manufacture of certain nonbeverage products. Advice has been requested whether quantitative formulas for nonbeverage products which contain specially denatured alcohol derived from a purchased ingredient may be approved. *Held*, a formula containing a purchased ingredient made with specially denatured alcohol may be approved, if within the requirements of the law and regulations in other respects, as eligible for drawback on the taxpaid ethyl alcohol used by the manufacturer submitting the formula, but under the condition that the specially denatured alcohol must have been recovered or completely dissipated from the ingredient in which used if the product is intended for internal use. If the product is not for internal consumption (flavors for use on tobacco, for example, would not be for internal consumption), it is not essential that the specially denatured alcohol be recovered or dissipated. The use, however, of specially denatured alcohol, as such, and taxpaid distilled spirits in the same product by a nonbeverage manufacturer may be conducive to fraud on the revenue and is not permitted where drawback of tax is involved.

SUBPART G.—GENERAL PROVISIONS

SECTION 5142.—PAYMENT OF TAX

Rev. Rul. 56-232

Section 5142 of the Internal Revenue Code of 1954 provides that the special (occupational) taxes imposed under Chapter 51 shall be paid by stamps denoting the tax. Title 18, U. S. C., section 8, 62 Stat. 685, defines "obligation or other security of the United States" to include "stamps and other representatives of value" issued under any Act of Congress. Title 18, U. S. C., section 474, 62 Stat. 706, makes it a criminal offense to print, photograph, or in any other manner make or execute any engraving, photograph, print, or impression in the likeness of any such obligation or other security, or any part thereof. Accordingly, photographs may not be made of special tax stamps.

SUBCHAPTER B.—DISTILLERIES

PART I.—ESTABLISHMENT

SECTION 5176.—DISTILLER'S BOND

26 CFR 220.186: Surety or security. Rev. Rul. 56-198

Section 220.186 of the Regulations relating to the Production of Distilled Spirits provides, in part, that where a distiller operates an internal revenue bonded warehouse on the distillery premises and Form 30, Distiller's Bond, is in the maximum penal sum of $100,000, it may be accepted without surety if it is supported by the consent of

surety on Form 1571, Transportation and Warehousing Bond, and the latter bond is in the maximum penal sum of $200,000. *Held*, a surety does not assume liability beyond the $200,000 maximum on the transportation and warehousing bond, Form 1571, by executing Form 1533, Consent of Surety, to support a distiller's bond, Form 30, given without surety or security in accordance with the provisions of section 220.186 of the regulations.

SECTION 5178.—PLAN OF DISTILLERY

26 CFR 220.171: Plat and plans. T. D. 6165[1]
(Also 221.179; Section 5231; 225.51.)

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER E—PARTS 220, 221, AND 225

Miscellaneous amendments

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On October 13, 1955, a notice of proposed rulemaking with respect to parts 220, 221, and 225 of title 26 (1954) of the Code of Federal Regulations was published in the Federal Register (20 F. R. 7664). The purpose of this proposal was to effect administrative decisions (1) to eliminate requirements for the weighing, prior to shipment, of packages transferred in sealed conveyances between internal revenue bonded warehouses and to transfer to proprietors the responsibility for weighing and recording the weights thereof of all packages transferred whether in sealed or unsealed conveyances, (2) to eliminate the requirement that packages be weighed prior to the dumping of spirits into tanks for gauging for either taxpayment or bottling in bond, (3) to provide for recoopering and repairing of packages under general supervision of an internal revenue officer, (4) to permit the taking of samples of spirits under general supervision of an internal revenue officer, (5) to transfer to warehousemen the responsibility for performing and recording certain original gauges of containers filled from storage tanks, (6) to authorize the storekeeper-gaugers to approve applications to change the kind of cooperage, (7) to provide that warehousemen shall furnish storekeeper-gaugers in charge with advance schedules of planned operations, (8) to authorize the transfer of spirits by pipeline to the bottling-in-bond department for gauge therein, (9) to provide for affixing brand labels or State stamps to bottled spirits (bearing all mandatory information) after removal from the premises where the spirits were bottled, (10) to remove restrictions as to bottle sizes for bottled-in-bond spirits to be exported, (11) to require the warehouseman to prepare Form 1620 when spirits are returned to the storage portion of the warehouse from the bottling-in-bond department, (12) to liberalize the requirements for the preparation and submission of plats and plans, (13) to permit such openings

[1] 21 F. R. 1850.

as are necessary in the wall separating the bottling-in-bond department from the storage portion of the warehouse, (14) to modify the requirements relating to the storage capacity of warehouses, (15) to delete the requirements with respect to marking storage tanks, (16) to eliminate the requirement for storing cases in serial order, (17) to permit alternate bottling from different tanks in the bottling-in-bond department, (18) to correct discrepancies in part 225 with respect to the preparation of Form 1520, the use of facsimile signature stamps on wholesale liquor dealer's stamps, and an incomplete cross reference, (19) to modify the degree of supervision to be exercised by internal revenue officers over various warehouse activities such as the transfer of spirits from one storage tank to another, transfer of spirits between warehouse buildings on the same premises, pipeline removals, filling of tank cars and tank trucks, and the transfer of rum for denaturation, and (20) to make changes of an editorial nature. No data, views, or arguments relating to the rules proposed were received within the period of 30 days from the date of publication. The amendments to 26 CFR (1954) parts 220, 221, and 225 set forth below are hereby adopted:

PARAGRAPH 1. 26 CFR (1954) part 220, Production of Distilled Spirits, is amended as follows:

(A) Section 220.171 is amended by striking the phrase "plans of the buildings, apparatus, and equipment thereon," and inserting in lieu thereof the phrase "flow diagrams (plans) of the distillery operations,".

(B) Section 220.210 is amended to read as follows:

§ 220.210 GENERAL REQUIREMENTS.—Every person intending to engage in the business of a distiller must, as provided in § 220.171, file an accurate plat of the distillery premises, and flow diagrams (plans) of the distillery operations, in triplicate, with the assistant regional commissioner. The Assistant Regional Commissioner may require the submission of other plans, including floor and elevational plans, when he deems such plans necessary to adequately depict any part of the premises or any details of construction or equipment. (68A Stat. 631; 26 U. S. C. 5179.)

(C) Section 220.211 is amended as follows:

(1) By changing the second sentence, which begins "The cardinal points", to read: "The cardinal points of the compass must appear on each sheet of any plat."

(2) By changing the sixth sentence, which begins "The dimensions", to read:

The dimensions of plat and plan sheets shall be 15 by 20 inches, outside measurement, with a clear margin of at least 1 inch on each side of the drawing, lettering, and writing: *Provided*, That the assistant regional commissioner may authorize the use of sheets which exceed these dimensions, if they can be folded to the 15-inch by 20-inch dimensions to permit the fastening of the sheets to a file by the top margin (20-inch dimension) in such a manner that they may be reviewed without removal from the file and will not unfold when the file is suspended in a cabinet.

(3) By changing the period at the end of the last sentence to a colon and adding the following: "*Provided*, That reproduction by other equally suitable methods may be approved by the assistant regional commissioner."

(D) Section 220.214 is revoked.

(E) Section 220.215 is amended to read as follows:

§ 220.215 PIPE LINES IN COLORS.—The pipe lines required to be shown on the plat and plans must be depicted in the colors in which they are painted, as prescribed by § 220.127. (68A Stat. 631; 26 U. S. C. 5178.)

(F) Section 220.216 is amended to read as follows:

§ 220.216 PIPE LINES EXEMPTED.—Utility service lines, such as sewers and electric or gas conduits or pipes, and sprinkler, refrigeration, or heating systems which have no connection with the distilling equipment or any apparatus or pipe line connected therewith, need not be shown on plans. (68A Stat. 631; 26 U. S. C. 5178.)

(G) Section 220.217 is amended to read as follows:

§ 220.217 FLOW DIAGRAMS.—Flow diagrams (plans) shall be submitted covering the distilling systems. The flow diagrams must reflect the description of each production process listed in the statement of process required by § 220.172. Such flow diagrams shall clearly depict equipment in its relative operating sequence, with essential connecting pipe lines and valves. The flow diagrams must show the flow of the distilling material through the beer well, stills, doublers, try boxes, and other essential equipment, and the deposit of the finished spirits in the cistern room. Such equipment as pumps, pressure regulators, weirs, or rotometers need not be shown. All major equipment must be identified as to number and use. The direction of the flow of spirits through the pipe line must be indicated on the flow diagrams by arrows. (68A Stat. 631; 26 U. S. C. 5178.)

(H) Section 220.256 is amended as follows:

(1) By striking from the first sentence the phrase "correctly describe and depict the distillery premises and the buildings, apparatus, and equipment thereon, to be taken over by the successor" and inserting in lieu thereof "are accurate".

(2) By striking from the second sentence the phrase "the distillery premises, and the buildings, apparatus, and equipment thereon, are correctly described and depicted on".

(3) By inserting immediately before the period at the end of the second sentence the words "are accurate".

(I) Section 220.264 is amended by inserting, immediately after the first sentence, the following new sentence:

The Assistant Regional Commissioner may require the distiller to submit drawings, photographs, or diagrams of such proposed change, if deemed necessary to accurately depict the purpose and method of the change.

(J) Section 220.267 is amended by inserting, immediately after the first sentence, the following new sentence:

The Assistant Regional Commissioner may require the distiller to submit drawings, photographs, or diagrams of such proposed changes, if deemed necessary to accurately depict the purpose and method of the changes.

(K) Section 220.595 is amended by placing a period after the phrase "transferred in sealed conveyances" in the third sentence, which begins "If the applicant", and striking the remainder of the sentence.

(L) Section 220.611 is amended as follows:

(1) By changing the headnote to read: "CERTIFICATE OF REMOVAL."

(2) By inserting in the first sentence, immediately after the phrase "removal of the spirits", the phrase "in containers other than packages".

(3) By inserting immediately after the second sentence the following new sentence:

If the spirits are transferred in packages the distiller shall certify on all copies of Form 236 as to the accuracy of the description of the packages and the removal thereof, and if the spirits are contained in a conveyance sealed with Government cap seals the storekeeper-gauger will note on Form 236 the serial numbers of the cap seals used.

(4) By striking from the third sentence, which begins "He will retain", the word "He" and inserting in lieu thereof the words "The storekeeper-gauger".

(M) Section 220.612 is amended by placing a period after the phrase "transferred in sealed conveyances" in the third sentence, which begins "If the applicant", and striking the remainder of the sentence.

(N) Section 220.619 is amended as follows:

(1) By changing the headnote to read: "CERTIFICATE OF REMOVAL."

(2) By inserting in the first sentence, immediately after the phrase "removal of the spirits", the phrase "in containers other than packages".

(3) By inserting immediately after the second sentence the following new sentence:

If the spirits are transferred in packages the distiller shall certify on all copies of Form 236 as to the accuracy of the description of the packages and the removal thereof, and if the spirits are contained in a conveyance sealed with Government cap seals the storekeeper-gauger will note on Form 236 the serial numbers of the cap seals used.

(4) By striking from the third sentence, which begins "He will retain", the word "He" and inserting in lieu thereof the words "The storekeeper-gauger".

PAR. 2. 26 CFR (1954) part 221, Production of Brandy, is amended as follows:

(A) Section 221.179 is amended by striking the phrase "plans of the buildings, apparatus, and equipment thereon," and inserting in lieu thereof the phrase "flow diagrams (plans) of the distillery operations,".

(B) Section 221.215 is amended to read as follows:

§ 221.215 GENERAL REQUIREMENTS.—Every person intending to engage in the business of a fruit distiller must, as provided in § 221.179, file an accurate plat of the distillery premises, and flow diagrams (plans) of the distillery operations, in triplicate, with the assistant regional commissioner. The assistant regional commissioner may require the submission of other plans, including floor and elevational plans, when he deems such plans necessary to adequately depict any part of the premises or any details of construction or equipment. (68A Stat. 631, 917; 26 U. S. C. 5178, 7805)

(C) Section 221.216 is amended as follows:

(1) By changing the second sentence, which begins "The cardinal points", to read: "The cardinal points of the compass must appear on each sheet of any plat."

(2) By changing the sixth sentence, which begins "The dimensions", to read:

The dimensions of plat and plan sheets shall be 15 by 20 inches, outside measurement, with a clear margin of at least 1 inch on each side of the drawing, lettering, and writing: *Provided*, That the assistant regional commissioner may authorize the use of sheets which exceed these dimensions, if they can be folded to the 15-inch by 20-inch dimensions to permit the

fastening of the sheets to a file by the top margin (20-inch dimension) in such a manner that they may be reviewed without removal from the file and will not unfold when the file is suspended in a cabinet.

(3) By changing the period at the end of the last sentence to a colon and adding the following: "*Provided*, That reproduction by other equally suitable methods may be approved by the assistant regional commissioner."

(D) Section 221.219 is revoked.

(E) Section 221.220 is amended to read as follows:

§ 221.220 FLOW DIAGRAMS.—Flow diagrams (plans) shall be submitted covering the distilling systems. The flow diagrams must reflect the description of each production process listed in the statement of process required by § 221.180. Such flow diagrams shall clearly depict equipment in its relative operating sequence, with essential connecting pipelines and valves. The flow diagrams must show the flow of the distilling material through the measuring tank, stills, doublers, try boxes, and other essential equipment, and the deposit of the finished brandy in the receiving tanks. Such equipment as pumps, pressure regulators, weirs, or rotometers need not be shown. All major equipment must be identified as to number and use. The direction of the flow of brandy through the pipeline must be indicated on the flow diagrams by arrows. (68A Stat. 631; 26 U. S. C. 5178.)

(F) Section 221.221 is amended to read as follows:

§ 221.221 PIPELINES IN COLORS.—The pipelines required to be shown on the plat and plans must be depicted in the colors in which they are painted, as prescribed by § 221.136.

(G) Section 221.222 is amended to read as follows:

§ 221.222 PIPELINES EXEMPTED.—Utility service lines, such as sewers and electric or gas conduits or pipes, and sprinkler, refrigeration, or heating systems which have no connection with the distilling equipment, or any apparatus or pipeline connected therewith, need not be shown on plans. (68A Stat. 631; 26 U. S. C. 5178.)

(H) Section 221.261 is amended as follows:

(1) By striking from the first sentence the phrase "correctly describe and depict the distillery premises and the buildings, apparatus, and equipment thereon, to be taken over by the successor" and inserting in lieu thereof "are accurate".

(2) By striking from the second sentence the phrase "the distillery premises, and the buildings, apparatus, and equipment thereon, are correctly described and depicted on".

(3) By inserting immediately before the period at the end of the second sentence the words "are accurate".

(I) Section 221.270 is amended by inserting, immediately after the first sentence, the following new sentence:

The Assistant Regional Commissioner may require the distiller to submit drawings, photographs, or diagrams of such proposed change, if deemed necessary to accurately depict the purpose and method of the change.

(J) Section 221.273 is amended by inserting, immediately after the first sentence, the following new sentence:

The Assistant Regional Commissioner may require the distiller to submit drawings, photographs, or diagrams of such proposed changes, if deemed necessary to accurately depict the purpose and method of the changes.

(K) Section 221.595 is amended by placing a period after the phrase "transferred in sealed conveyances" in the third sentence,

which begins "If the applicant", and striking the remainder of the sentence.

(L) Section 221.611 is amended as follows:

(1) By changing the headnote to read: "CERTIFICATE OF REMOVAL."

(2) By inserting in the first sentence, immediately after the phrase "removal of the brandy", the phrase "in containers other than packages".

(3) By inserting immediately after the second sentence the following new sentence:

If the brandy is transferred in packages the distiller shall certify on all copies of Form 236 as to the accuracy of the description of the packages and the removal thereof, and if the brandy is contained in a conveyance sealed with Government cap seals the storekeeper-gauger will note on Form 236 the serial numbers of the cap seals used.

(4) By striking from the third sentence, which begins "He will retain", the word "He" and inserting in lieu thereof the words "The storekeeper-gauger".

(M) Section 221.612 is amended by placing a period after the phrase "transferred in sealed conveyances" in the third sentence, which begins "If the applicant", and striking the remainder of the sentence.

(N) Section 221.619 is amended as follows:

(1) By changing the headnote to read: "CERTIFICATE OF REMOVAL."

(2) By inserting in the first sentence, immediately after the phrase "removal of the brandy", the phrase "in containers other than packages".

(3) By inserting immediately after the second sentence the following new sentence:

If the brandy is transferred in packages the distiller shall certify on all copies of Form 236 as to the accuracy of the description of the packages and the removal thereof, and if the brandy is contained in a conveyance sealed with Government cap seals the storekeeper-gauger will note on Form 236 the serial numbers of the cap seals used.

(4) By striking from the third sentence, which begins "He will retain", the word "He" and inserting in lieu thereof the words "The storekeeper-gauger".

PAR. 3. 26 CFR (1954) part 225, Warehousing of Distilled Spirits, is amended as follows:

(A) Section 225.51 is amended by striking from the proviso of the first sentence the words "not more than two" and inserting in lieu thereof the word "communicating".

(B) Section 225.52 is amended by changing the period at the end of the first sentence to a colon and adding the following:

Provided, That in any area or locality where commercial internal revenue bonded warehouse facilities are not available and it is impracticable to have a warehouse of 5,000 barrels or more capacity in the locality, and the necessity for establishment is shown, the Director, Alcohol and Tobacco Tax Division, may authorize the establishment of a warehouse without regard to such minimum storage requirements.

(C) Section 225.72 is amended as follows:

(1) By changing the fourth sentence, which begins "No door, window," to read as follows:

The Assistant Regional Commissioner may authorize such communicating doors to the storage portion of the warehouse and such openings for use in transferring empty cases from the empty container storeroom as may be necessary for efficient operation of the bottling-in-bond department when, in his opinion, such doors and openings do not constitute a jeopardy to the revenue.

(2) By inserting immediately after the fifth sentence, which begins "Communicating doors", the following new sentence:

Any opening in the wall or partition separating the bottling-in-bond department from the empty container storeroom must be provided with a substantial door or other suitable closure equipped for locking in the inside of the bottling-in-bond department and must be kept locked except while being used.

(3) By striking from the last sentence the words "boarded or bricked up" and inserting in lieu thereof the word "closed".

(D) Section 225.155 is amended by changing the third sentence, which begins "The applicant", to read as follows:

The applicant in such case shall submit with the application sworn statements from distillers respecting their intentions to deposit spirits in the warehouse, and from other persons respecting their intentions to store spirits in the warehouse, and showing the estimated quantities proposed to be deposited or stored therein and the frequency of withdrawals therefrom.

(E) Section 225.166 is amended by striking the phrase "an accurate plat of the warehouse premises and accurate plans of the buildings, apparatus and equipment" and inserting in lieu thereof the phrase "plat and plans".

(F) Section 225.220 is amended to read as follows:

§ 225.220 GENERAL REQUIREMENTS.—Every person intending to engage in business as the proprietor of an internal revenue bonded warehouse must, as provided in § 225.166, file an accurate plat of the warehouse premises, in triplicate, with the Assistant Regional Commissioner. Where the warehouse consists of, or includes, only a portion of a building, floor plans for each floor of such portion must be filed, in triplicate, with the Assistant Regional Commissioner. Where a bottling-in-bond department is to be established, floor plans of the bottling-in-bond department must be filed. The Assistant Regional Commissioner may require the submission of other plans, including floor plans and elevational drawings, when he deems such plans necessary to adequately depict any part of the premises or any details of construction or equipment. (68A Stat. 643; 26 U. S. C. 5231.)

(G) Section 225.221 is amended as follows:

(1) By striking from the second sentence the words ", except those of elevational plans".

(2) By changing the period at the end of the sixth sentence, which begins "The dimensions", to a colon and adding the following:

Provided, That the Assistant Regional Commissioner may authorize the use of sheets which exceed these dimensions, if they can be folded to the 15-inch by 20-inch dimensions to permit the fastening of the sheet to a file by the top margin (20-inch dimension), in such a manner that they may be reviewed without removal from the file and will not unfold when the file is suspended in a cabinet.

(3) By changing the period at the end of the last sentence to a colon and adding the following: "*Provided*, That reproduction by other equally suitable methods may be approved by the Assistant Regional Commissioner."

(H) Section 225.224 is amended to read as follows:

§ 225.224 FLOOR PLANS.—The plans shall consist of a floor plan of the bottling-in-bond department (if any) or where the warehouse consists of, or includes, only a portion of a building, each floor of such portion, showing the general dimensions of the rooms or floors, and the location of all doors, windows, and other openings, and how such openings are protected. If the construction of all floors in a single building, required to be depicted on plans, is identical, a typical floor plan may be filed in lieu of a separate plan (required under this section and § 225.220) for each floor. The floor plans for a bottling-in-bond department must show all tanks and equipment used in connection with the receipt, gauging, and bottling of distilled spirits and their exact location and designated use. Serial numbers and capacities of all tanks shall also be shown. (68A Stat. 643, 645; 26 U. S. C. 5231, 5243.)

(I) Section 225.225 is revoked.

(J) Section 225.226 is amended by striking the words "must be shown on the plans" and inserting in lieu thereof the words "required to be shown on the plat or plans must be depicted".

(K) Section 225.227 is amended to read as follows:

§ 225.227 PIPELINES EXEMPTED.—Utility service lines, such as sewers and electric or gas conduits or pipes, and sprinkler, refrigeration, or heating systems which have no connection with equipment used for spirits, need not be shown on the plans. (68A Stat. 643; 26 U. S. C. 5231.)

(L) Section 225.250 is amended as follows:

(1) By striking from the first sentence the phrase "correctly describe and depict the warehouse premises and the buildings, apparatus and equipment thereon, to be taken over by the successor" and inserting in lieu thereof "are accurate".

(2) By striking from the second sentence the phrase "the warehouse premises and the buildings, apparatus, and equipment thereon are clearly described and depicted on".

(3) By inserting immediately before the period at the end of the second sentence the words "are accurate".

(M) Section 225.261 is amended by inserting, immediately after the first sentence, the following new sentence: "The Assistant Regional Commissioner may require the warehouseman to submit drawings, photographs, or diagrams of such proposed change, if deemed necessary to accurately depict the purpose and method of the change."

(N) Section 225.262 is amended by inserting, immediately after the first sentence, the following new sentence: "The Assistant Regional Commissioner may require the warehouseman to submit drawings, photographs, or diagrams of such proposed changes, if deemed necessary to accurately depict the purpose and method of the changes."

(O) Section 225.280 is amended as follows:

(1) By striking the words "his real name or the trade name" and inserting in lieu thereof the words "the name (real or trade)".

(2) By inserting immediately after the words "in which the warehouse is" the words "qualified and".

(3) By inserting immediately after the words "he may bottle" the word "any".

(P) Section 225.309 is amended by adding at the end of item (a) in the first sentence the following: "unless the Director, Alcohol and Tobacco Tax Division, has authorized its establishment exempt from these minimum storage requirements, as provided in § 225.52,".

(Q) By inserting a new section, reading as follows, immediately after § 225.351:

§ 225.351a PROPRIETOR'S SCHEDULE OF OPERATIONS.—The proprietor shall furnish daily to the storekeeper-gauger in charge a schedule of operations for the next succeeding work day. This schedule shall show all activities which require the immediate supervision or attention of a storekeeper-gauger, such as, the approximate number of containers of spirits to be received and withdrawn (identify kinds of withdrawals), the quantity of spirits to be bottled in bond, bulk regauge and taxpayment operations, the time and approximate number of packages to be recoopered, number and quantity of samples to be taken, number of containers to be filled from storage tanks or consolidation tanks, and repairs which will involve the breaking or replacing of seals or the manipulation of Government locks.

(R) Section 225.353 is amended by inserting in the first sentence, immediately after the phrase "equipped for locking", the parenthetical phrase "(if required by this part)".

(S) Section 225.358 is amended to read as follows:

§ 225.358 SUPERVISION OF OPERATIONS.—In all instances where immediate supervision by the storekeeper-gauger of any operation is not required by this part the storekeeper-gauger shall, from time to time, make spot checks of the operations being conducted by the warehouseman to satisfy himself of the propriety of the operation. Where the storekeeper-gauger finds significant discrepancies in entries or records made by the warehouseman, the marks or brands required to be placed on any container, or finds any operation being conducted contrary to the provisions of this part, the warehouseman shall take such corrective action as may be required by the storekeeper-gauger. (68A Stat. 644; 26 U. S. C. 5241.)

(T) By inserting a new section, reading as follows, immediately after § 225.358:

§ 225.358a INSPECTION OF PACKAGES IN STORAGE.—The Assistant Regional Commissioner will, from time to time, assign internal revenue officers for the purpose of inspecting packages of distilled spirits to determine the extent of tampering or losses through theft.

(U) Section 225.373 is amended by striking from the fourth sentence, which begins "The storekeeper-gauger", the word "storekeeper-gauger" and inserting in lieu thereof the word "warehouseman".

(V) Section 225.376 is revoked.

(W) Section 225.378 is amended by striking from the last sentence the word "immediate".

(X) Section 225.380 is amended to read as follows:

§ 225.380 FROM DISTILLERY NOT ON THE SAME OR CONTIGUOUS PREMISES OR FROM ANOTHER WAREHOUSE.—When spirits are received from a distillery not on the same or contiguous premises or from another internal revenue bonded warehouse for deposit, the warehouseman will examine and weigh each package and enter the weight on Form 1520 or Form 1619, as the case may be, except as follows:

(a) The weighing of packages will not be required where spirits are transferred in bond in conveyances sealed with Government cap seals in accordance with the provisions of § 225.732 and the conveyances are received with such seals intact;

(b) The weighing of packages will not be required where spirits are received from a distillery or warehouse, operated by the consignee or an affiliate or subsidiary of the consignee, in the immediate vicinity and the location of both premises is such that the transfer can be under observation of the internal revenue officers; and

(c) The requirement for weighing of packages, subsequent to transfer in unsealed conveyances, may be waived by the Assistant Regional Commissioner, upon authorization by the Director, Alcohol and Tobacco Tax Division, pursuant to a written application filed with the assistant regional commissioner by the warehouseman, if it is found that, due to the proximity of the premises or other attendant conditions, the revenue would not be jeopardized. Where packages are received without weighing the warehouseman will so indicate in the appro-

priate column on Form 1520 or 1619. If weighing is not required the warehouseman may elect to weigh the packages and enter the receiving gross weights on Form 1520 or 1619. When conveyances are received upon which the Government cap seals are not intact, or if packages bear evidence of damage in transit, the warehouseman will weigh each package under the supervision of the storekeeper-gauger. The warehouseman shall report the receipt of packages in unsealed conveyances to the storekeeper-gauger who shall inspect such packages and supervise the weighing thereof, except where the Assistant Regional Commissioner has waived the requirement for weighing. Where material discrepancies between shipping and receiving weights are found or where containers bear evidence of having sustained loss in transit the storekeeper-gauger will follow the procedure prescribed in § 225.381. The procedure prescribed in § 225.382 will be followed as to spirits received in tank cars or tank trucks. (68A Stat. 604; 26 U. S. C. 5011.)

(Y) Section 225.381 is amended to read as follows:

§ 225.381 EXAMINATION OF PACKAGES.—Where packages of spirits are received bearing evidence of having sustained unusual losses in transit, or where material discrepancies are found by the comparison of the shipping weight with the receiving weight, the storekeeper-gauger will (a) examine the condition of the cooperage of each such package and (b) gauge each such package and enter the details thereof in the appropriate columns on Form 1520 or 1619, as the case may be, and in the loss column enter the difference in weight between the amount shipped and the amount received. The storekeeper-gauger will not on the reverse of the Form 1520 or 1619 the condition of the cooperage and whether in his opinion the loss was occasioned by theft, accident, or other determinable cause. In the event the loss sustained from any package appears to have been the result of theft, such package will be detained and a report made to the assistant regional commissioner in accordance with § 225.486. (68A Stat. 604; 26 U. S. C. 5011.)

(Z) Section 225.401 is amended by striking from the fifth sentence, which begins "The cases may", the phrase, "and kept arranged in serial order".

(AA) Section 225.406 is amended to read as follows:

§ 225.406 FACILITIES FOR RECOOPERING.—The proprietor shall provide a suitable enclosed area, in which the repair or recoopering of all packages, involving exposure of spirits, shall be conducted. The proprietor shall lock the enclosure when spirits are exposed therein unless the employee responsible for recoopering activities is present: *Provided*, That locking of the enclosure is not required if the spirits have been deposited in locked containers. The facilities to be used must be so arranged and the work so performed that supervision by storekeeper-gaugers can be performed readily and expeditiously and unnecessary loss or wastage of spirits or unauthorized mingling will be prevented. (68A Stat. 633, 634, 643; 26 U. S. C. 5193, 5194, 5231.)

(BB) Section 225.407 is amended to read as follows:

§ 225.407 GAUGING.—Distilled spirits may be drawn into packages from storage tanks in accordance with this part. If the distilled spirits in the tank are found to be other than a whole degree of proof, adjustment to a whole degree shall be made by the proprietor before withdrawal into packages. Each package will be carefully gauged by the warehouseman, under the general supervision of the storekeeper-gauger, and the details thereof will be entered by the warehouseman on Form 1520: *Provided*, That where the warehouseman has indicated that packages are to be withdrawn on the original gaue the storekeeper-gauger shall, unless the packages are to be withdrawn without payment of tax for use in wine production, make such gauge and report the details thereof on Form 1520, noting thereon, "Withdraw on original gauge". When the warehouseman makes the gauge the total number of barrels shown on Form 1520 to have been filled shall be verified by him. Any cask or package which contains or has on its interior or exterior any substance that will prevent the correct ascertainment of tare shall not be used. Whenever there is a change in the specifications as to capacity and weight of cooperage, the warehouseman shall give notice to the storekeeper-gauger. The tare of the empty package will be determined and recorded on Form 1520. Weights shall be determined in pounds and one-half pounds. (68A Stat. 633, 634; 26 U. S. C. 5193, 5194.)

(CC) Section 225.408 is amended by striking from the second sentence the word "immediate".

(DD) Section 225.409 is amended by striking from the fifth sentence, which begins "All marking", the word "immediate".

(EE) Section 225.410 is amended by changing the first sentence to read: "The date of original entry for deposit and the proof of distillation of the spirits shall be noted on each copy of Form 1520."

(FF) Section 225.413 is amended by changing the third sentence, which begins "The storekeeper-gauger", to read "The tare of the new package will be determined and will be marked on the package before transfer of the spirits."

(GG) Section 225.414 is amended by striking the word "immediate".

(HH) Section 225.415 is amended as follows:

(1) By striking the words "assistant regional commissioner" and inserting in lieu thereof the word "storekeeper-gauger".

(2) By placing a period after the phrase "spirits are stored" and striking the remainder of the sentence.

(II) Section 225.416 is amended to read as follows:

§ 225.416 REQUEST TO STOREKEEPER-GAUGER.—The request for permission to change the kind of cooperage must give the serial number of the package or packages, kind of original cooperage, kind of cooperage desired to be used, name of the distiller, registered number and location (city or town, and State) of the distillery at which the spirits were produced and the reason why the change is desired. Storekeeper-gaugers in charge may approve the request when internal revenue officers are available for necessary supervision.

(JJ) Section 225.417 is amended to read as follows:

§ 225.417 MARKING NEW PACKAGES.—Each new package will be given the same serial number, marks, and brands (except the tare and kind of cooperage) as the original package, and will contain only spirits from one package. The tare of the new package will be determined and will be marked on the new package before the transfer, and upon completion of the transfer the proprietor will prepare and sign a label to be affixed to the head of each new package in the manner prescribed in this part for the affixing of wholesale liquor dealer's stamps. The label shall be in the following form:

The spirits contained in this package, serial No. _____, were transferred to new _____ barrel under date of _____ by authority of
(Kind of cooperage)
letter dated _____. The package from which the spirits herein were transferred was a _____ barrel.
(Kind of cooperage)

_____
(Proprietor)

When such a change of package is made, the storekeeper-gauger will note the tare of the new package on Form 1520 or Form 1619 covering deposit of the spirits. If the new package should be transferred in bond the proprietor will make a notation on the transfer Form 1619 showing the date of the change of package and the tare of the new package.

(KK) Section 225.433 is amended by striking from the first sentence the phrase "and the spirits shall be transferred under the supervision of the storekeeper-gauger" and inserting in lieu thereof the phrase "and may then effect the transfer".

(LL) Section 225.485 is amended by striking the third, fourth, fifth, sixth, and seventh sentences.

(MM) By inserting a new section, reading as follows, immediately after § 225.485:

§ 225.485a LOSSES DETERMINED IN WAREHOUSE INSPECTION OR AT TIME OF RECOOPERING.—Where a package or other container which has

sustained an unusual loss from obvious cause other than theft or unauthorized voluntary destruction is found on warehouse inspection or where an unusual loss is determined at the time of recoopering, the warehouseman shall make a report of gauge on Form 1698. A copy of the form will be securely attached to the package and two copies will be delivered to the storekeeper-gauger. When Form 1698 is prepared by the warehouseman for any package the new gross weight, date, and the serial number of the Form 1698 will be noted by the storekeeper-gauger on the deposit form. (68A Stat. 604; 26 U. S. C. 5011)

(NN) Section 225.536 is amended as follows:

(1) By inserting immediately after the word "removed" in item (d) the following phrase: "and specific information as to the location of the package or packages in the warehouse".

(2) By striking immediately before item (k) the word "and".

(3) By changing the period at the end of the last sentence to a comma and adding the following: "and (1) the approximate time the samples will be taken."

(OO) Section 225.537 is amended by striking from the last sentence the phrase "(j) and (k)" and inserting in lieu thereof the phrase "and (j) through (l)".

(PP) Section 225.540 is amended to read as follows:

§ 225.540 REMOVAL UNDER SUPERVISION.—The removal of samples will be subject to the supervision of the storekeeper-gauger. (68A Stat. 667; 26 U. S. C. 5373.)

(QQ) Section 225.541 is amended as follows:

(1) By changing the period at the end of the third sentence, which begins "The proprietor" to a semicolon and adding the following: "(i) The words "Subject to taxpayment" where the label is to be placed upon a sample taken subject to payment of tax."

(2) By changing the fourth and fifth sentences, which begin "Upon completion," and "Where the label", respectively, to read:

Such label and copy shall be signed and dated by the employee responsible for taking the sample and immediately above the signature there will appear the following statement: "I certify that this sample was taken in the quantity and from the package described above and from no other package." The employee shall affix the label to the sample container and give the copy to the storekeeper-gauger.

(RR) Section 225.542 is amended by striking from the last sentence the phrase "At the time of preparing Form 1520 or Form 1619 covering the" and inserting in lieu thereof the word "Upon".

(SS) Section 225.562 is amended as follows:

(1) By striking from the first sentence the words "to be".

(2) By striking the last sentence.

(TT) Section 225.563 is amended to read as follows:

§ 225.563 PREPARATION OF WITHDRAWAL REPORTS BY STOREKEEPER-GAUGER.—When spirits are withdrawn from a storage tank in an internal revenue bonded warehouse into packages which are to be withdrawn on the original gauge (except packages to be withdrawn without payment of tax for use in wine production), when spirits are removed by pipeline or in tank cars or tank trucks, or when spirits are taxpaid in gauge tanks, the storekeeper-gauger will prepare and complete the Form 1520 in accordance with the instructions in this part. (68A Stat. 639, 649; 26 U. S. C. 5215, 5250.)

(UU) Section 225.565 is amended to read as follows:

§ 225.565 WITHDRAWAL ON ORIGINAL GAUGE.—Distilled spirits in packages, tank cars, or tank trucks, except as provided in §§ 225.491 and 225.912, may be withdrawn from an internal revenue bonded warehouse on the original gauge if such gauge was made by a storekeeper-gauger. Where the gauge was made pursuant to notification from the distiller or warehouseman, as the case may be, that the spirits would be withdrawn on the original gauge, and the deposit forms for such spirits bear the notification "Withdraw on the original gauge"; the spirits must be withdrawn on the original gauge unless permission for a regauge is first obtained from the Assistant Regional Commissioner. (68A Stat. 647; 26 U. S. C. 5215.)

(VV) Section 225.571 is amended to read as follows:

§ 225.571 WEIGHING PACKAGES.—During the process of weighing, care will be taken to note the correct reading of the scale to the half pound and in case of doubt as to which graduation shall apply, the graduation denoting the lesser weight will prevail. (68A Stat. 639; 26 U. S. C. 5212.)

(WW) Section 225.572 is amended by striking the first and second sentences and inserting in lieu thereof the following new sentences:

The proof of spirits shall be determined in accordance with the instructions set forth in the Gauging Manual (Part 186 of this title). The storekeeper-gauger shall determine, or verify, as the case may be, the proof of all spirits gauged.

(XX) Section 225.573 is revoked.

(YY) Section 225.576 is amended by striking the second sentence, which begins "The spirits", and inserting in lieu thereof the following new sentence: "The spirits will be carefully gauged and the details entered on the report of gauge as provided in this part."

(ZZ) Section 225.580 is amended as follows:

§ 225.580 PIPELINE REMOVALS.—Pipelines used for the transfer of spirits to qualified establishments on the same or contiguous premises, or to tank cars or tank trucks for shipment, must conform to the requirements of § 225.124, except that the spirits may be transferred into or from a tank car or tank truck by means of a hose connection where the operation can be under the observation of an internal revenue officer. The valves on such pipelines shall be kept closed and locked, except during the transfer of spirits, which transfer shall be under the supervision of an internal revenue officer. (68A Stat. 599, 634, 636; 26 U. S. C. 5006, 5194, 5195.)

(AAA) Section 225.590 is amended as follows:

(1) By inserting in the first sentence, immediately after the words "will be determined", the phrase ", under the supervision of the storekeeper-gauger,".

(2) By striking the second sentence, which begins "The storekeeper-gauger".

(BBB) Section 225.601 is amended by striking from the third sentence, which begins "If the", the words "entered in columns 11 and 12" and inserting in lieu thereof the words "shown on Form 1520".

(CCC) Section 225.630 is amended as follows:

(1) By changing the comma following the phrase "stated on Form 179" in the second sentence, which begins "Where the spirits", to a period and striking the remainder of the sentence.

(2) By striking from the fourth sentence, which begins "Where the capacity", the phrase "a separate Form 1520 must be prepared for each such gauging tank listing the packages to be gauged therein, and".

(3) By striking from the last sentence the phrase "in accordance with §§ 225.632 to 225.636".

(DDD) Section 225.632 is amended as follows:

(1) By changing the first sentence to read as follows: "If the spirits to be withdrawn are in packages, the storekeeper-gauger, upon receipt of the Form 179, will carefully examine each package and will verify the identity of the spirits."

(2) By inserting immediately after the second sentence, which begins "Where it is", the following new sentence: "The storekeeper-gauger will satisfy himself that each package which does not bear such evidence has been dumped into the gauging tank."

(3) By changing the tenth sentence, which begins "The spirits in", to read as follows: "The spirits in the gauging tank will be gauged with an official hydrometer and the details of the gauge and the number of the gauging tank shall be entered by the storekeeper-gauger on Form 1520, in quintuplicate."

(4) By inserting immediately after the tenth sentence the following new sentence: "A separate Form 1520 must be prepared by the storekeeper-gauger for each gauging tank."

(EEE) Section 225.637 is amended by striking from the second sentence, which begins "The removal of", the word "immediate".

(FFF) Section 225.675 is amended by placing a period after the phrase "provisions of §§ 225.642 and 225.643" in the first sentence and striking the remainder of the sentence.

(GGG) Section 225.732 is amended as follows:

(1) By inserting in the first sentence immediately after the words "weighing of spirits" the words "prior to transfer of".

(2) By inserting in the third sentence, which begins "If the conveyance", immediately after the words "packages at the" the words "consignor and".

(HHH) Section 225.733 is amended by placing a period after the phrase "transferred in sealed conveyances" in the third sentence, which begins "If the applicant", and striking the remainder of the sentence.

(III) Section 225.735 is amended to read as follows:

§ 225.735 TRANSFERS IN PACKAGES.—When the proprietor of the shipping warehouse desires to make shipment of spirits in packages, he will prepare an original and five copies of Form 1619 filling in the heading and giving details as to serial numbers, date of original entry for deposit, original gauge and last gauge (if other than the original) and will identify any packages designated to be withdrawn on the original gauge by the notation "Withdraw on original gauge". In the case of blended brandies the proprietor shall also show on Form 1619 the date and serial number of the Form 1685 covering the blending of the brandies, the date of the original entry of the oldest brandy in the blend and the date of the original entry of the youngest brandy in the blend. The proprietor shall execute on the six copies of Form 236 a description of the packages to be transferred. If the proprietor elects to ship the packages in a Government-sealed conveyance when the consignee-warehouseman has not previously requested a sealed conveyance as provided by § 225.733, he should indicate on Form 236 that the packages are to be transferred in sealed conveyances; otherwise the proprietor should indicate that the packages are to be shipped in unsealed conveyances. The weighing of packages is not required where the spirits are transferred in conveyances sealed with Government cap seals, or where the spirits are to be transferred to an internal revenue bonded warehouse operated by the consignor or an affiliate or subsidiary of the consignor in the immediate vicinity and so located that the transfer can be under observation by internal revenue officers; however, if the warehouseman elects to weigh such packages he will enter the shipping gross weights on Form 1619. Where packages are to be shipped in conveyances not sealed with Government cap seals the warehouseman will examine and weigh each package under the supervision of the storekeeper-gauger and enter the shipping gross weight on Form 1619. Where it is determined by the warehouseman or the storekeeper-

gauger that any package bears evidence of unusual loss that cannot be satisfactorily explained, or of tampering, such package will be detained pending further investigation in accordance with the applicable provisions of §§ 225.480 to 225.495. Where a package which has sustained an unusual loss from obvious cause other than theft or unauthorized voluntary destruction is found upon preparation for transfer, the package will be weighed and proofed by the storekeeper-gauger and the apparent cause noted on Form 1619. The quantity to be transferred shall not exceed the maximum stated in the application. Upon withdrawal for transfer to noncontiguous premises, the word "Transferred" followed by the date of transfer, the number of the receiving warehouse, and the State in which such warehouse is located, will be plainly and durably stenciled on the Government head of the package in letters and figures not less than one-half inch in height. These marks may be abbreviated as follows:

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Upon completion of the lading of the packages and the preparation of Forms 236 and 1619 the proprietor will deliver all copies of each form to the storekeeper-gauger. Forms 236 and 1619 will be disposed of in accordance with the provisions of § 225.750. (68A Stat. 606, 647; 26 U. S. C. 5023, 5246.)

(JJJ) Section 225.738 is amended as follows:

(1) By changing the first sentence to read as follows:

When the proprietor desires to transfer spirits in packages, tank cars, or tank trucks, to be filled from warehouse storage tanks, he will deliver a copy of Form 236 with a complete description of the spirits to the storekeeper-gauger in charge of the warehouse.

(2) By changing the second sentence, which begins "Upon receipt", to read: "Upon receipt of the Form 236 the spirits designated to be transferred will be drawn into packages, gauged (as provided in § 225.407), marked, and branded, or run into a gauging tank, gauged (by the storekeeper-gauger), and conveyed by pipeline into a railroad tank car or tank trucks, constructed and marked as provided in this subpart."

(3) By changing the third sentence, which begins "The storekeeper-gauger", to read: "The proof at which the spirits were distilled shall be noted on the original and five copies of Form 1520 covering the report of gauge."

(4) By inserting in the fifth sentence, which begins "The storekeeper-gauger in charge", immediately after the words "six copies of Form 1520", the parenthetical phrase "(except when Form 1520 was prepared by the proprietor as provided in § 225.407)".

(KKK) Section 225. 747 is amended as follows:

(1) By striking the first and second sentences and inserting in lieu thereof the following new sentence: "Tank cars or tank trucks will be filled under the supervision of the storekeeper-gauger."

(2) By striking the fourth sentence, which begins "The officer", and inserting in lieu thereof the following new sentence:

The level of the spirits above or below the full mark for each compartment, and the temperature of the spirits at filling will be entered on Form 1520, for example:
"Filled two inches above full mark at 80° F."

(LLL) Section 225.750 is amended as follows:

(1) By changing the headnote to read: "CERTIFICATE OF REMOVAL."

(2) By inserting in the first sentence immediately after the words "of the spirits" the phrase "in containers other than packages".

(3) By inserting immediately after the first sentence the following new sentence:

If spirits are transferred in packages the warehouseman shall certify on all copies of Form 236 as to the accuracy of the description of the packages and the removal thereof, and if the spirits are contained in a conveyance sealed with Government cap seals the storekeeper-gauger will note on Form 236 the serial numbers of the cap seals used.

(MMM) Section 225.751 is amended as follows:

(1) By changing the headnote to read: "RECEIPT OF SPIRITS AT WAREHOUSE."

(2) By striking the first three sentences and inserting in lieu thereof the following new sentences:

Upon receipt of the spirits at the receiving warehouse, losses or discrepancies will be ascertained and noted on Form 1520, 1619, or 1620, as the case may be, as provided in §§ 225.381, 225.382, and 225.384. The warehouseman will examine and weigh packages of spirits as provided in § 225.380 and will execute the certificate of receipt and deposit on Form 236. If the spirits are contained in a conveyance sealed with Government cap seals the storekeeper-gauger will indicate on all copies of Form 236 whether the conveyance was received with the seals intact and if the spirits are received in containers other than packages will execute the certificate of receipt and deposit.

(NNN) Section 225.752 is amended by placing a period after the phrase "transferred in sealed conveyances" in the third sentence, which begins "If the applicant", and striking the remainder of the sentence.

(OOO) Section 225.755 is amended as follows:

(1) By changing the headnote to read: "CERTIFICATE OF REMOVAL."

(2) By inserting in the first sentence immediately after the words "of the spirits" the phrase "in containers other than packages".

(3) By inserting immediately after the first sentence the following new sentence:

If spirits are transferred in packages the warehouseman shall certify on all copies of Form 236 as to the accuracy of the description of the packages and the removal thereof, and if the spirits are contained in a conveyance sealed with Government cap seals the storekeeper-gauger will note on Form 236 the serial numbers of the cap seals used.

(PPP) Section 225.756 is amended as follows:

(1) By changing the headnote to read "RECEIPT OF SPIRITS AT WAREHOUSE."

(2) By striking the first three sentences and inserting in lieu thereof the following new sentences:

Upon receipt of the spirits at the receiving warehouse, losses or discrepancies will be ascertained and noted on Form 1520, 1619, or 1620, as the case may be, as provided in §§ 225.381, 225.382, and 225.384. The warehouseman will examine and weigh packages of spirits as provided in § 225.380 and will execute the certificate of receipt and deposit on Form 236. If the spirits are contained in a conveyance sealed with Government cap seals the storekeeper-gauger will indicate on all copies of Form 236 whether the conveyance was received with the seals intact and if the spirits are received in containers other than packages will execute the certificate of receipt and deposit.

(QQQ) Section 225.912 is amended as follows:

(1) By inserting imediately after the words "officer to gauge" in the fourth sentence, which begins "Where no storekeeper-gauger", the parenthetical phrase "(when necessary)".

(2) By changing the seventh sentence, which begins "If the packages", to read: "Packages filled at a distillery or filled in an internal revenue bonded warehouse from storage tanks may be withdrawn on the basis of the guage made at the time of filling."

(3) By striking from the eighth sentence, which begins "The proprietor will", the phrase "the proof and tare ascertained at the time of withdrawal,".

(4) By striking the last sentence.

(RRR) Section 225.935 is amended by striking from the first sentence the word "immediate".

(SSS) Section 225.951 is amended as follows:

(1) By changing the comma following the word "quadruplicate" in the first sentence to a period and striking the remainder of the sentence.

(2) By changing the second sentence, which begins "Upon receipt", to read: "Upon receipt of the application the storekeeper-gauger will satisfy himself that the spirits are eligible for bottling in bond and will inspect the packages."

(3) By striking from the fifth sentence, which begins "The packages", the words "and weighed".

(4) By striking the last sentence.

(TTT) Section 225.952 is amended to read as follows:

§ 225.952 GAUGE.—Packages of distilled spirits to be bottled in bond may be (a) dumped and gauged in the storage portion of the warehouse, (b) dumped in the storage portion of the warehouse and transferred to the bottling-in-bond department for gauging, or (c) removed to the bottling-in-bond department, dumped, and gauged. If the spirits are to be gauged and transferred to the bottling-in-bond department by pipeline, the packages will be dumped in the bulk gauge tank in the warehouse. The storekeeper-gauger will make his gauge of the spirits, report the details thereof on Form 1520, in triplicate, and complete his report on Form 1515. The storekeeper-gauger will also enter on Form 1520 the number of the gauging tank. If the spirits are to be removed in packages to the bottling-in-bond department or are to be gauged after receipt by pipeline in the bottling-in-bond department, the storekeeper-gauger in the warehouse will complete his certificate of removal for bottling on Form 1515. When the spirits have been released for transfer to a bottling-in-bond department, all copies of the application and the Form 1520, if gauged in a warehouse gauging tank, will be furnished to the storekeeper-gauger assigned to the bottling-in-bond department in order that such officer may inspect the spirits prior to the bottling thereof. If the spirits are received in the bottling-in-bond department in packages, they will be dumped for bulk gauging in dumping and reducing or in bottling tanks. Where the spirits are transferred to the bottling-in-bond department by pipeline prior to gaguging they will be deposited in dumping and reducing or in bottling tanks. The storekeeper-gauger will make his gauge, either by weight or by volume, and will report the gauge on Forms 1520 and 1515 in the same manner as if the spirits had been gauged in the warehouse. He will at that time return the original of the Form 1520 to the storekeeper-gauger in charge of the warehouse. When the bottling is completed, the storekeeper-gauger will enter the details of the cases on Form 1515, forward one copy, with the Form 1520 attached, to the Assistant Regional Commissioner, deliver one copy of each form to the proprietor, return one copy of Form 1515 to the storekeeper-gauger in charge of the warehouse, and file the remaining copy of Form 1515 in the bottling-in-bond department. Spirits taxpaid from the bottling department shall be considered as constructively returned to the storage portion of the warehouse. The storekeeper-gauger shall account for, as deposited, on Forms 1621 and 1513, all spirits bottled. Prior to the removal of cases of distilled spirits

from the bottling-in-bond department, the proprietor will prepare Form 1620, in triplicate, and submit it to the storekeeper-gauger for signature. One copy of the form will be forwarded to the Assistant Regional Commissioner, one copy will be given to the warehouseman, and the remaining copy will be filed as a permanent record as provided in § 225.1102. (68A Stat. 645; 26 U. S. C. 5243.)

(UUU) Section 225.953 is amended by striking the period at the end of the second sentence and all of the third sentence, which begins "The proprietor", and inserting in lieu thereof the following: "and deliver all copies to the storekeeper-gauger in charge of the warehouse."

(VVV) Section 225.954 is amended as follows:

(1) By changing the first sentence to read: "Upon receipt of Form 1515 the storekeeper-gauger will examine the application and request for gauge."

(2) By striking from the last sentence the words "no discrepancies are found in the Form 1520 and".

(WWW) Section 225.955 is amended by changing the fifth sentence, which begins "Prior to", to read: "Prior to the removal of cases of spirits from the bottling-in-bond department, the proprietor will prepare Form 1620, in triplicate, and submit it to the storekeeper-gauger for signature."

(XXX) Section 225.960 is amended by inserting in the first sentence immediately after the words "tank for bottling in bond" the phrase "or which have been dumped in the warehouse but are to be gauged in the bottling-in-bond department."

(YYY) Section 225.962 is amended by striking from the first sentence the words "gauging room".

(ZZZ) Section 225.963 is amended by striking from the last sentence the words "gauging room" and inserting in lieu thereof the words "storage portion of the warehouse".

(AAAA) Section 225.964 is amended to read as follows:

§ 225.964 SPIRITS IN PROCESS OF BOTTLING.—The bottling of two or more lots of spirits at the same time in the same bottling room must be conducted in such a manner as to prevent any mingling of different lots of spirits, either in the filling of bottles or in the placing of the filled bottles in cases. The process of bottling will be regarded as complete when the bottled spirits have been placed in the cases and the cases closed. Outlets to bottling tanks in which spirits are contained must be locked at all times when such spirits are not in the process of being bottled. The proprietor shall not dump more spirits than can be bottled expeditiously. (68A Stat. 645; 26 U. S. C. 5243,)

(BBBB) Section 225.966 is amended by striking from the first sentence the word "immediate".

(CCCC) Section 225.972 is amended by striking from the last sentence the word "immediate".

(DDDD) Section 225.974 is amended to read as follows:

§ 225.974 REMOVAL OF SPIRITS BOTTLED FOR DOMESTIC PURPOSES.—On completion of bottling, the filled bottles, with labels and strip stamps properly affixed, must be placed in cases marked in accordance with Subpart 00 of this part, and the filled cases then sealed, after which such cases must be immediately taxpaid and removed, removed tax-free or without payment of tax for any authorized purpose, or returned to the storage portion of the bonded warehouse: *Provided*, That the Assistant Regional Commissioner may authorize the proprietor to remove cases temporarily sealed to the storage portion of the warehouse, pending the receipt of orders involving affixing of brand labels or State stamps or the transfer in bond to another internal revenue bonded warehouse where brand labels or State stamps will be affixed. The affixing of the bottled-in-bond strip stamps, the caution notices, and the label information required under 27 CFR part 5 will be

performed at the time of bottling and before the goods are returned to the storage portion of the warehouse. However, if all of the mandatory information required under 27 CFR Part 5 appears on the brand label in lieu of a separate label, the brand label must be affixed to the bottles before the goods are returned to the storage portion of the warehouse. When orders are received (either at the bottling warehouse or the consignee warehouse) for the spirits in cases temporarily sealed as provided in this section, the cases must be removed to the bottling-in-bond department for affixing the brand label, or the State stamp, or both: *Provided,* That the Assistant Regional Commissioner may authorize such affixing of brand labels or State stamps, or both, in the storage portion of the warehouse where the need therefor is established, space and facilities for such activities are available, and the necessary supervision can be provided without the assignment of additional internal revenue officers. The brand label to be affixed must be covered by an appropriate certificate of label approval or a certificate of exemption from label approval required by 27 CFR Part 5. When spirits in cases temporarily sealed are removed to the bottling-in-bond department or are transferred in bond to another internal revenue bonded warehouse they must be kept apart from other spirits until the work of attaching the brand label, or State stamp, or both, and permanent sealing of the cases has been completed.

(EEEE) Section 225.985 is amended by striking the first and second sentences and inserting in lieu thereof the following new sentence: "Distilled spirits shall be bottled in bond for export in bottles containing less than 5 wine gallons."

(FFFF) Section 225.997 is amended by striking the word "quintuplicate" and inserting in lieu thereof the word "quadruplicate".

(GGGG) Section 225.1016 is revoked.

(HHHH) Section 225.1046 is amended as follows:

(1) By striking from the first sentence the word "and in no other".

(2) By inserting immediately after the first sentence the following new sentence:

When bottles containing spirits are of sizes for which stamps in the exact denominations are not provided, the warehouseman will use stamps of the denomination nearest the actual quantity of spirits contained in the bottles, and will strike out the original denomination and print or write on the stamps the exact quantity of spirits contained in the bottles.

(IIII) Section 225.1066 is amended as follows:

(1) By changing the first sentence to read:

All rebottling, relabeling, and restamping of spirits must be conducted in a bottling-in-bond department under the supervision of a storekeeper-gauger: *Provided,* That the Assistant Regional Commissioner may authorize the relabeling or restamping of spirits in the storage portion of an internal revenue bonded warehouse where the need therefor is established, space and facilities for usch activities are available, and the necessary supervision can be provided without the assignment of additional internal revenue officers.

(2) By striking from the last sentence the words "where two or more complete bottling units are installed".

(JJJJ) Section 225.1103 is amended by changing the first sentence to read as follows:

When spirits are to be withdrawn, the storekeeper-gauger shall, upon presentation of the proper withdrawal form by the proprietor, secure from his file the Form 1520, 1619, or 1620, covering the deposit of the spirits, including blended brandy returned to the storage portion of the warehouse from the brandy-blending department, and except for packages transferred in bond shall verify the details of the entry gauge transcribed to the withdrawal form.

Because it is necessary to provide regulations which will enable internal revenue bonded warehouses to operate with less supervision

by Government officers, it is hereby found impracticable to issue this Treasury Decision subject to the effective date limitations of section 4(c) of the Administrative Procedure Act (60 Stat. 238; 5 U. S. C. 1003(c)). Accordingly, this Treasury Decision shall be effective on the date of publication in the Federal Register.

(This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U. S. C. 7805).)

RUSSELL C. HARRINGTON,
Commissioner.

Approved March 21, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary of the Treasury in Charge of Tax Policy.

(Published in the Federal Register March 27, 1956)

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26 CFR 220.217: Flow diagrams. Rev. Rul. 56-281
(Also Section 221.220.)

The Internal Revenue Service establishes more detailed instructions relative to flow diagrams required to be submitted by proprietors of registered and fruit distilleries.

Treasury Decision 6165, page 716, this Bulletin, among other things, amended the Regulations relating to the Production of Distilled Spirits and the Regulations relating to the Production of Brandy to liberalize the requirements thereof with respect to distillery plats and plans. Sections 220.217 and 221.220 of the respective regulations, as amended, now require the submission of flow plans covering the distilling system only.

The flow diagram should begin at the beer well and must clearly depict, from that point, equipment in its relative operating sequence, with connecting pipelines and valves. It should show the flow of the distilling material into the still, all doublers, condensers, try boxes, low and high wine tanks, and other equipment, and the deposit of the finished spirits in the cistern room. All major equipment shown on the flow diagram must be identified as to the number and use. To illustrate, if there are six high wine tanks, the diagram need show only one, appropriately identified as "6 H. W. Tks." The direction of the flow of the spirits through the pipelines must be indicated by arrows. It is not necessary to show pumps, pressure regulators, weirs, rotometers, feed lines to control instruments, and similar equipment.

The flow diagram must reflect the description of production set forth in the statement of processes submitted by the distiller. Where two or more production processes are employed by a distiller and it is not possible to show each process on one flow diagram in a clear, concise, and readily understandable manner, flow diagrams for each such process are required. However, where two or more products are produced by the same process, such as bourbon and corn whisky, only one flow diagram is necessary covering such process.

26 CFR 221.179: Plat and plans.

Simplified procedures in the weighing, transferring, and keeping records of packages of distilled spirits. See T. D. 6165, page 716.

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26 CFR 221.220: Flow diagrams.

For instructions relative to submission of flow plans by proprietors of fruit distilleries, see Rev. Rul. 56–281, page 735.

PART II.—OPERATION

SECTION 5193.—DRAWING, GAUGING, AND MARKING OF DISTILLED SPIRITS

26 CFR 220.389: Immediate deposit required. Rev. Rul. 56–96
(Also Section 220.535.)

> Distilled spirits of the same class, type, and proof of production may be deposited in the same receiving cistern at a registered distillery on consecutive days, provided the accumulated spirits are withdrawn on or before the third working day following the initial deposit therein.

Advice has been requested whether finished spirits may be accumulated in the same receiving cistern in a registered distillery for more than one day before reporting the production thereof on prescribed forms.

Section 5193 of the Internal Revenue Code of 1954 and section 220.535 of the Regulations relating to the Production of Distilled Spirits, require that distilled spirits deposited into receiving cisterns be withdrawn therefrom on or before the third working day after such deposit. Section 220.389 of the regulations, with respect to the deposit of spirits in a receiving cistern, requires that spirits so deposited be of the same class, type, and proof of production.

It is held that finished spirits of the same class, type, and proof of production may be deposited in the same receiving cistern at a registered distillery on consecutive working days. However, in such case, the accumulated spirits must be withdrawn on or before the third working day following the *initial* deposit therein.

The quantities of spirits deposited in the receiving cistern should be determined by volumetric gauge and recorded daily, as memorandum entries only, on Form 1598, Proprietor's Report of Operations at Registered Distillery, and Form 1686, U. S. Storekeeper-gauger's Record of Operations at Registered Distillery or Industrial Alcohol Plant. The production should be recorded on Forms 1598 and 1686 in the applicable columns at the time of gauge and removal from the receiving cistern, in accordance with the instructions on such forms.

26 CFR 225.400: Kinds of containers. T. D. 6173[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER E, PART 225.—WAREHOUSING OF DISTILLED SPIRITS

Amendment relating to the consolidation of packages

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On January 19, 1956, a notice of proposed rulemaking with respect to part 225 of title 26 (1954) of the Code of Federal Regulations was published in the Federal Register (21 F. R. 399). The purpose of this proposal was to provide for the consolidation of packages of spirits distilled at 190 degrees of proof or more from the same class of materials by the same distiller at the same distillery and stored in the same kind of cooperage under approximately the same conditions and which are otherwise homogeneous. After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the following amendments to 26 CFR (1954) part 225 are hereby adopted.

PARAGRAPH 1. Section 225.400 is amended by changing the semicolon at the end of paragraph (c) to a comma and adding the following, "or in consolidated packages filled in accordance with §§ 225.417a to 225.417g;".

PAR. 2. Section 225.409a is amended by inserting "225.417f," immediately after the reference to "225.417".

PAR. 3. By inserting, immediately after § 225.417, the following new undesignated center head and sections:

CONSOLIDATION OF PACKAGES

§ 225.417a AUTHORIZED CONSOLIDATION.—Spirits distilled at 190 degrees of proof or more, whether or not such proof is subsequently reduced, from the same class of materials, by the same distiller at the same distillery, and differing in periods of storage (a) not more than 6 months in the case of spirits stored in bond more than 2 years, (b) not more than 60 days in the case of spirits stored in bond more than 1 year and not more than 2 years, or (c) not more than 30 days in the case of spirits stored in bond 1 year or less, and stored in the same kind of cooperage under approximately the same conditions will be presumed to be homogeneous, and may, with the prior approval of the storekeeper-gauger in charge, be consolidated or combined in accordance with the provisions of this subpart. Such spirits may be repackaged in as many of the same packages or other packages of the same kind of cooperage as may be necessary.

§ 225.417b EQUIPMENT FOR CONSOLIDATION OF PACKAGES.—The proprietor of an internal revenue bonded warehouse who desires to consolidate spirits must provide suitable space for the dumping of the packages containing the spirits to be consolidated, repackaging of

[1] 21 F. R. 3006.

such spirits, and the gauging of the consolidated packages. Tanks of adequacy capacity, constructed in accordance with the provisions of § 225.111, shall be provided. If bulk gauging tanks or storage tanks have been provided, such tanks may be utilized in lieu of installing separate consolidation tanks. The facilities to be used must be so arranged and the work so performed that supervision by storekeeper-gaugers can be performed readily and expeditiously and unnecessary loss or wastage of spirits or unauthorized mingling will be prevented.

§ 225.417c Application for Consolidation of Spirits.—When it is desired to consolidate spirits contained in packages, application for consolidation must be made to the storekeeper-gauger in charge by the proprietor of the warehouse. The application must be submitted in triplicate, and shall identify the serial numbers of the packages, the total original tax gallons for all such packages (when spirits of more than one season's production are listed, the total original tax gallons for each season shall be shown), kind of original cooperage, class of materials from which produced, name of the producing distiller, and registry number and location (city or town, and State) of the distillery, the dates on which it is desired to conduct such operations, and the purpose therefor. Each application shall be given a serial number, beginning with "1" for the first day of January of each year and running consecutively thereafter to December 31, inclusive. In addition, where the warehouseman desires to subsequently withdraw the spirits on the original gauge of the consolidated packages he shall note on all copies of the application, "withdraw on original gauge." Storekeeper-gaugers in charge will approve the application only where suitable space and equipment is available and internal revenue officers are available for necessary supervision. If the storekeeper-gauger approves the application he will return one copy marked "Approved" to the proprietor, and retain the remaining two copies.

§ 225.417d Dumping and Gauging.—Upon removal of the packages, authorized by the approved application, to that portion of the warehouse where the spirits are to be consolidated, the storekeeper-gauger will examine the packages. Any package bearing evidence of unusual loss that cannot be satisfactorily explained, or of tampering, shall be detained pending further investigation in accordance with the applicable provisions of §§ 225.480 to 225.495. The storekeeper-gauger will satisfy himself that each package which does not bear such evidence has been dumped into the tank. All packages must be thoroughly drained and if any of the packages are not to be refilled as consolidated packages such packages must be thoroughly rinsed. Rinse water not used in reducing the proof of the spirits must be destroyed, or collected in locked tanks for transfer by pipeline to a distillery on or contiguous to the warehouse premises for redistillation as provided in § 225.417h. Immediately upon being emptied all marks and brands must be obliterated from the packages and the packages removed from the warehouse: *Provided*, That, if any such packages are to be used for containers for consolidated spirits, so many as are required for that purpose may be retained and the name, location, and registry number of the producing distiller; the designation of the kind of cooperage; the proof of distillation; the kind of spirits; and the date of original filling, if all the

spirits mingled were entered for deposit on the same date, may be left intact thereon. Spirits in the consolidation tank shall be thoroughly agitated and adjusted to a whole degree of proof by the proprietor. The storekeeper-gauger shall then verify the proof, see that all openings in the tank are locked, determine (volume or weight) the quantity of spirits in the tank and report the details of the gauge on all copies of the application.

§ 225.417e FILLING AND GAUGING CONSOLIDATED PACKAGES.—When the spirits are to be drawn from the tank the storekeeper-gauger shall see that all valves and openings other than the necessary outlet valves are closed and locked. All spirits drawn into packages will be carefully gauged by the warehouseman, under the general supervision of the storekeeper-gauger, and the details thereof will be entered by the warehouseman on Form 1520, in triplicate; *Provided*, That, where the warehouseman has indicated on his application that the consolidated packages are to be withdrawn on the original gauge, the storekeeper-gauger shall, unless the packages are to be withdrawn without payment of tax for use in wine production, make such gauge and report the details thereof on Form 1520, noting on Form 1520, "Withdraw on original gauge." There shall be noted on Form 1520 the date of the original entry for deposit of the oldest spirits mingled in the tank. The composite proof determined in the tank shall be used for the consolidated packages. Weights shall be determined in pounds and one-half pounds. Where the gauge of the packages is performed and reported by the warehouseman the storekeeper-gauger shall, from time to time, verify the tares, gross weights, and tax gallonages. Where the storekeeper-gauger finds significant discrepancies in the warehouseman's report of gauge, or the marks and brands required to be placed on any container, the warehouseman shall make such corrections as may be required by the storekeeper-gauger. Tanks must be completely emptied before the inlets thereto may be unlocked. Where a remnant package results because of insufficient spirits remaining in the tank to fill the last package, such package shall be gauged and marked in the same manner as the other consolidated packages. Remnant packages may be consolidated in accordance with the provisions of § 225.417a. Losses of spirits resulting from the repackaging operation shall be reported by the storekeeper-gauger on the application by indicating the difference between the total quantity dumped in the tank and the total quantity repackaged. Upon completion of the gauging of the packages and the preparation of the gauge forms, one copy of the approved application and one copy of the Form 1520 covering the details of the repackaging will be forwarded to the assistant regional commissioner by the storekeeper-gauger, one copy of each will be retained by the proprietor, and one copy of each will be placed in the appropriate file in the Government office.

§ 225.417f *Numbering, Marking, and Branding of Consolidated Packages.*—All consolidated packages shall be serially numbered, separately from packages filled at the distillery, from storage tanks in the bonded warehouse, or from brandy-blending tanks in the bonded warehouse, beginning with the number "1," preceded by the letters "CP" (Consolidated Package) and the registry number and State identifying the warehouse, as CP–12–Ind.–1, etc. The symbol "CP"

together with the registry number and State shall be considered a part of the serial number and must be shown on all official forms and records. The consolidated packages shall be marked and branded in accordance with the applicable provisions of § 225.409. The date of filling of the consolidated packages should be abbreviated, as "Con. 7-20-55". Where distilled spirits with different dates of original entry are consolidated, the date of the oldest spirits so mingled shall govern the entire lot and such date shall be marked on packages to indicate the date of original entry of the spirits for deposit.

§ 225.417g *Withdrawal of Consolidated Spirits.*—When the proprietor desires to withdraw spirits which have been consolidated, application therefor will be prepared in the same manner as for the withdrawal of any other spirits, and the withdrawal will be made in accordance with the applicable provisions of this part. The date of consolidation will be noted on Form 1520, or, in the case of transfer in bond, on Form 1619.

§ 225.417h *Collection and Transfer of Rinse Water for Redistillation.*—Rinse water collected for redistillation shall be held in closed, locked tanks until transferred by pipeline to a distillery on or contiguous to the warehouse premises. Rinse water obtained from spirits which are not homogeneous under the provisions of this part may not be mingled. Where rinse water is accumulated in a tank, an extra copy of Form 1520, prepared in accordance with § 225.417e, 225.601, 225.630, 225.810, 225.952, or 225.953, will be prepared and attached to the tank to identify the class and type of spirits. When the rinse water is to be transferred to a distillery for redistillation, it will be gauged by the proprietor (by weight or by volume). The proprietor will prepare a report of the gauge on Form 1520, in quintuplicate. The rinse water shall be given the same designation as the spirits contained in the packages from which it was obtained, preceded by the word "Diluted," as, for example, "Diluted Neutral Spirits—Grain." On completion of the transfer, three copies of the Form 1520 will be given to the storekeeper-gauger at the distillery, one copy will be filed in a special file by the storekeeper-gauger at the warehouse, and the remaining copy will be retained in the files of the proprietor. The receipt and redistillation of the rinse water at the distillery shall be in accordance with the applicable provisions of part 220 or part 221 of this chapter, as the case may be, relating to receipt and redistillation of distilled spirits. (68A Stat. 634; 26 U. S. C. 5194)

PAR. 4. Section 225.602 is amended by striking the seventh sentence, which begins, "Where the proprietor" and inserting in lieu thereof the following new sentence, "Rinse water which is not added to the spirits must be destroyed in the presence of the storekeeper-gauger, or collected in locked tanks for transfer by pipeline to a distillery for redistillation as provided in § 225.417h."

PAR. 5. Section 225.632 is amended by striking from the sixth sentence, which begins, "The rinsings" the phrase "poured on the ground or into a sewer in the presence of the storekeeper-gauger." and inserting in lieu thereof the phrase "destroyed in the presence of the storekeeper-gauger, or collected in locked tanks for transfer by pipeline to a distillery for redistillation as provided in § 225.417h."

PAR. 6. Section 225.731 is amended by striking from the second sentence the word "Spirits" and inserting in lieu thereof the phrase "Except as provided in §§ 225.417a to 225.417g, spirits".

PAR. 7. Section 225.754 is amended by inserting in the first sentence, immediately after the phrase "or in packages filled from warehouse storage tanks," the phrase "or in consolidated packages,".

PAR. 8. Section 225.811 is amended by striking the period at the end of the second sentence and adding thereto the phrase ", or collected in locked tanks for transfer by pipeline to a distillery for redistillation as provided in § 225.417h."

PAR. 9. Section 225.962 is amended by striking the third sentence, which begins, "Any rinse water", and inserting in lieu thereof the following new sentence, "Any rinse water remaining after such reduction must be destroyed in the presence of the storekeeper-gauger, or collected in locked tanks for transfer by pipeline to a distillery for redistillation as provided in § 225.417h; it may not be mixed with spirits dumped from other packages."

PAR. 10. Section 225.1102 is amended as follows:

(A) By inserting in the first sentence, immediately after the phrase "Forms 1520 covering packages filled from brandy-blending tanks,", the phrase "Forms 1520 covering consolidated packages,".

(B) By inserting at the end of the sixth sentence, which begins "Separate files", the words "and for consolidated packages".

PAR. 11. Section 225.1103 is amended by inserting in the first sentence, immediately after the words "brandy-blending department", the words "or spirits contained in consolidated packages".

PAR. 12. Section 225.1104 is amended by inserting in the third sentence, which begins "The binders", immediately after the phrase "packages of blended brandy filled in the brandy-blending department,", the phrase "consolidated packages,".

PAR. 13. Section 225.1106 is amended by inserting immediately after the first sentence a new sentence reading, "Copies of applications for the consolidation of packages will be filed separately in numerical order.".

PAR. 14. Section 225.1111 is amended by inserting, immediately after the second sentence, which begins "All information", the following two new sentences:

The total original tax gallon content of packages dumped for consolidation shall be included as "withdrawn" in Form 1513 and the tax gallons of spirits drawn from consolidation tanks into packages will be included as "deposited". The quantity of spirits lost during repackaging will not be shown in the account on Form 1513.

PAR. 15. Section 225.1140 is amended by inserting, immediately after the third sentence, which begins "In the case", the following new sentence:

In the case of consolidated packages (where spirits with different dates of original entry were mingled) the season and year of the oldest spirits mingled shall be considered the season and year of the entire lot.

This Treasury Decision shall become effective on the 31st day following the date of its publication in the Federal Register.

(This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U. S. C. 7805).)

O. Gordon Delk,
Acting Commissioner.

Approved May 1, 1956.

Dan Throop Smith,
Special Assistant to the Secretary in Charge of Tax Policy.

(Published in the Federal Register May 5, 1956)

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26 CFR 220.535: Drawing off spirits.

Accumulation of spirits in a receiving tank at a registered distillery. See Rev. Rul. 56–96, page 736.

SECTION 5194.—TRANSFER OF SPIRITS AT REGISTERED DISTILLERIES

26 CFR 221.515: For transfer to internal revenue bonded warehouses. (Also Section 5242; 225.370.)

T. D. 6171 [1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER E, PARTS 221 AND 225

Miscellaneous regulations

Department of the Treasury
Office of Commissioner of Internal Revenue,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

In order to authorize brandy of any proof to be transferred by pipeline and in tank cars or tank trucks to internal revenue bonded warehouses for deposit in storage tanks and subsequent packaging, with or without reduction in proof, 26 CFR parts 221 and 225 are amended as follows:

Paragraph 1. 26 CFR (1954) Part 221, Production of Brandy, is amended as follows:

(A) Section 221.515 is amended to read as follows:

§ 221.515 For Transfer to Internal Revenue Bonded Warehouses.—Brandy of any proof may be removed to internal revenue bonded warehouses, without, or after, reduction in proof as follows:

(a) In approved containers for storage in such approved containers or in storage tanks; and

(b) In wooden packages, each containing two or more metallic cans having a capacity of not less than 5 wine gallons each, for the purpose of exportation only.

(68A Stat. 633, 634, 640; 26 U. S. C. 5193, 5194, 5215.)

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[1] 21 F. R. 2657.

PAR. 2. 26 CFR (1954) Part 225, Warehousing of Distilled Spirits, is amended as follows:

(A) Section 225.370 is amended as follows:

(1) By striking from the first sentence the words "and wine spirits may be received by pipeline or in tank cars or tank trucks from a fruit distillery".

(2) By inserting in (a) of the proviso, after the words "by pipeline", the phrase "or in tank cars or tank trucks".

(B) Section 225.371 is amended as follows:

(1) By striking from the first sentence the words "and wine spirits may be received by pipeline or in tank cars or tank trucks from a fruit distillery".

(2) By inserting as (a) of the proviso the following:

(a) brandy of any proof may be received by pipeline or in tank cars or tank trucks from a fruit distillery for deposit in storage tanks;

(3) By redesignating (a) and (b) of the proviso as (b) and (c), respectively.

(C) Section 225.372 is amended as follows:

(1) By striking the words "and wine spirits received in tank cars or tank trucks from a fruit distillery,".

(2) By inserting in the proviso as (a) the following:

(a) brandy of any proof may be received in tank cars or tank trucks from a fruit distillery or internal revenue bonded warehouse for deposit in storage tanks;

(3) By redesignating (a) and (b) of the proviso as (b) and (c), respectively.

(D) Section 225.382 is amended by changing the proviso at the end of the fifth sentence to read, "*Provided*, That brandy, gin, or vodka may be transferred to storage tanks in accordance with § 225.402."

(E) Section 225.400 (d) (4) is amended to read as follows:

(4) In any warehouse, if the spirits are brandy, gin, or vodka: *Provided*, That tanks for the storage of vodka must be metal, porcelain, glass, or paraffin-lined; and

(F) The proviso at the end of the second sentence of § 225.402 is amended to read as follows:

Provided, That any brandy, gin, or vodka received in tank cars or tank trucks may be transferred to storage tanks.

(G) Section 225.408 is amended as follows:

(1) By inserting after the first sentence the following new sentence: "Brandy in warehouse storage tanks may be reduced in such storage tanks to not less than 100 degrees of proof prior to being drawn into packages.

(2) By amending the proviso at the end of the third sentence to read as follows:

Provided, That any brandy, gin, or vodka may be withdrawn from storage tanks into tank cars or tank trucks for transfer in bond.

(3) By amending the last sentence to read, "The proof of wine spirits intended for use in wine production may not be reduced."

(4) By amending the statutory citation to read, "(68A Stat. 634, 640; 26 U. S. C. 5194, 5215)".

(H) The undesignated centerheading preceding § 225.583 is amended to read, "Addition of Burnt Sugar or Caramel, or Oak Chips."

(I) The headnote of § 225.584 is amended to read, "ADDITION OF BURNT SUGAR OR CARAMEL AFTER TAX DETERMINATION."

(J) By inserting a new section, reading as follows, immediately after § 225.584:

§ 225.584a ADDITION OF BURNT SUGAR OR CARAMEL TO BRANDY IN STORAGE TANKS.—Caramel or burnt sugar may be added to brandy in storage tanks when the brandy is being reduced prior to being drawn into wooden packages. The burnt sugar or caramel shall not contain any substantial quantity of sugar which has not been caramelized, or possess any material sweeting properties. The caramel may be dissolved in a small quantity of hot water or in a small quantity of brandy removed from the tank for that purpose, before it is added to the bulk of the brandy in the tank. After the burnt sugar or caramel is added, the brandy in the tank will be thoroughly agitated and its proof determined. The proof so ascertained will be regarded as the proof of the brandy run into all packages filled from the tank. Packages containing brandy to which burnt sugar or caramel has been added, in addition to all other marks and brands required by this part, shall be marked with the letters, "B. S. A." A similar notation shall be made on Form 1520 covering the gauge of the brandy filled from the tank. (68A Stat. 607; 26 U. S. C. 5025.)

This Treasury Decision shall be effective on publication in the Federal Register.

Compliance with the public rulemaking and effective date requirements of section 4(a) and (c) of the Administration Procedure Act (60 Stat. 238; 5 U. S. C. 1003) is impracticable and unnecessary in connection with the issuance of this Treasury decision because the amendments are of a liberalizing nature and impose no new restrictions on the industry.

(This Treasury Decision is issued under the authority contained in 68A Stat. 917; 26 U. S. C. 7805.)

O. GORDON DELK,
Acting Commissioner of Internal Revenue.

Approved April 19, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Published in the Federal Register April 25, 1956)

PART III.—GENERAL PROVISIONS RELATING TO DISTILLERIES AND DISTILLED SPIRITS

SECTION 5216.—MASH, WORT AND VINEGAR: VINEGAR FACTORIES

26 CFR 221.790: Production of mash, wort, or wash. — Rev. Rul. 56-199

Concentrated apple juice to which water has been added may not be fermented by a fruit distiller on off-bonded premises.

SUBCHAPTER C.—INTERNAL REVENUE BONDED WAREHOUSES

PART I.—ESTABLISHMENT

SECTION 5231.—AUTHORITY TO ESTABLISH

26 CFR 225.51: Warehouse buildings.

Liberalization of constructional requirements as to the openings between the bottling-in-bond department and the storage portion of warehouse buildings. See T. D. 6165, page 716.

PART II.—OPERATION

SECTION 5242.—DEPOSITS OF SPIRITS IN WAREHOUSES

26 CFR 225.370: In warehouse on distillery premises.

Deposit of brandy in internal revenue bonded warehouse storage tanks and the subsequent packaging, with or without reduction in proof. See T. D. 6171, page 742.

SECTION 5247.—WITHDRAWAL OF SPIRITS FOR EXPORTATION

26 CFR 225.794: Continuing bond, direct export, Form 657. Rev. Rul. 56–80
(Also Sections 225.796 and 225.877.)

A consent of surety may be filed to extend the terms of a continuing export bond, Form 657, Export Bond for Distilled Spirits, Form 658, Transportation Bond—Distilled Spirits for Export, or Form 1618, Transportation Bond—Distilled Spirits Withdrawn for Transfer to Bonded Manufacturing Warehouse. See Revenue Ruling 54–237, C. B. 1954–1, 314, with respect to withdrawals from more than one warehouse under a continuing bond filed on Form 1618, and Revenue Ruling 54–291, C. B. 1954–2, 473, with respect to withdrawals under a continuing bond filed on Form 657. Where a consent of surety is filed to extend the terms of a continuing export bond to cover withdrawals from additional premises, the exporter must either (a) designate one establishment at which he desires the account with the bond to be maintained, or (b) apportion the coverage under the bond among the several premises. If the account is to be maintained at one establishment, all applications to remove spirits under continuing bonds on Forms 657, 658, or 1618 must be submitted to the storekeeper-gauger at that establishment and storekeeper-gaugers at other premises covered by the same bond must be advised of the procedure being followed. If the bond coverage is

apportioned, a consent, to the apportionment of the surety on the bond, must be filed, and the amount designated by the exporter for any plant or warehouse becomes the maximum bond coverage for exportation from that establishment. Exporters may reapportion the bond coverage if changing conditions make such action necessary, but consent of surety to such reapportionment must be filed and approval given only after the Assistant Regional Commissioner, Alcohol and Tobacco Tax, has ascertained that the condition of the account at each establishment is such as will permit the reapportionment.

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26 CFR 225.796: Continuing bond, transportation for export, Form 658.

For withdrawals from two or more premises under a single continuing export bond, see Rev. Rul. 56–80, above.

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26 CFR 225.877: Bond.

For withdrawals from two or more premises under a single continuing export bond, see Rev. Rul. 56–80, page 745.

SECTION 5248.—WITHDRAWAL OF SPIRITS WITHOUT PAYMENT OF TAX

26 CFR 182.630b: Reciprocating foreign countries. Rev. Rul. 56–81
(Also 225.861; Sections 5053, 5062, 5362; 245.291, 252.4, 240.691.)

Alcohol, distilled spirits, wine and fermented malt liquor may be withdrawn free of tax or with benefit of drawback for use as supplies on aircraft registered in the country of Lebanon and actually engaged in foreign trade or trade between the United States and its possessions, where trade by foreign aircraft is permitted. Accordingly, Revenue Ruling 54–576, C. B. 1954–2, 472, as modified by Revenue Ruling 55–362, C. B. 1955–1, 577, and Revenue Ruling 55–741, C. B. 1955–2, 702, is further modified to include the country of Lebanon.

As so modified, the Revenue Ruling reads as follows:

Under the provisions of section 309 of the Tariff Act of 1930, as amended, 46 Stat. 690, as amended, 19 U. S. C. 1309, and applicable regulations of the Internal Revenue Service, alcohol, distilled spirits, fermented malt liquor and wine may be withdrawn free of tax or with benefit of drawback for use as supplies on aircraft registered in the following foreign countries and actually engaged in foreign trade or trade between the United States and its possessions, where trade by foreign aircraft is permitted.

Australia
Bahama Islands
Belgium
Bermuda
Brazil
Canada
Costa Rica
Denmark
Ecuador
France
Germany, Federal Republic of
Israel
Italy
Japan
Lebanon
The Netherlands
Norway
Peru
Sweden
Switzerland
United Kingdom

26 CFR 225.861: Reciprocating foreign countries.

The country of Lebanon has been added to the list of reciprocating foreign countries. See Rev. Rul. 56–81, page 746.

SECTION 5285.—RECORDS AND RETURNS

26 CFR 235.815: Monthly record, Form 45.

For modification of information to be reported by proprietors of rectifying plants on Form 45, see Rev. Proc. 56–14, page 1039.

SUBCHAPTER E.—INDUSTRIAL ALCOHOL PLANTS, BONDED WAREHOUSES, DENATURING PLANTS, AND DENATURATION

PART I.—INDUSTRIAL ALCOHOL PLANTS, BONDED WAREHOUSES, AND DENATURING PLANTS

SECTION 5303.—ESTABLISHMENT OF INDUSTRIAL ALCOHOL DENATURING PLANTS

26 CFR 182.707: Denaturants not required to be tested. Rev. Rul. 56–240 [1]

Revenue Ruling 55–128, C. B. 1955–1, 589, contains a list of imitation essential oils and aromatic substances, denaturing grade, which have been approved as denaturants by the National Office for use in lieu of the natural oils.

Oil Lavender Technical E–1465, Denaturing Grade, manufactured by Verona Chemical Company, a synthetic oil lavender, has been approved for use in lieu of the natural oil of lavender. Accordingly, Revenue Ruling 55–128, *supra*, is hereby supplemented by adding thereto, under the heading "Oil of Lavender," the following:

Verona Chemical Co. Newark, N. J.	Oil Lavender Technical E–1465, D. G. Verona	Esters as Linalyl Acetate—71% minimum. Essential Oils—29% maximum

SECTION 5307.—PRODUCTION, USE OR SALE OF ALCOHOL

26 CFR 182.486: Bulk Containers. Rev. Rul. 56–241

Section 182.486 of the Industrial Alcohol Regulations lists the purposes for which alcohol may be disposed of in bulk (in containers having a capacity in excess of one gallon) as permitted by the Regulations relating to Bulk Sales and Bottling of Distilled Spirits, issued under the Federal Alcohol Administration Act. Such purposes include the industrial use of alcohol in bulk in the manufacture of medicinal, pharmaceutical, or antiseptic products, including prescriptions compounded by retail druggists. *Held*, the use of alcohol by doctors and dentists for such purposes as compounding, sterilization, antisepsis, etc., comes within the classification of "industrial use" provided in section 182.486.

[1] This Revenue Ruling has been amended by Revenue Ruling 56–352, I. R. B. 1956–30, page 103.

PART II.—DENATURATION

SECTION 5331.—WITHDRAWAL FROM BOND FREE OF TAX

26 CFR 182.140: Application, Form 1479.

For procedure with respect to filing an application on Form 1479 for amendment of basic permit, Form 1481, to include all articles and preparations covered by Forms 1479–A approved prior to and during the period covered by the permit, see Rev. Proc. 56–7, page 1023.

26 CFR 182.725: Approved containers. Rev. Rul. 56–200

A number of one-gallon cans of specially denatured alcohol, each bearing an individual serial number and all of the other marks required by the Industrial Alcohol Regulations, may be packaged in a single fiberboard case stencilled to show the contents, the specially denatured alcohol formula number, and the individual serial numbers of the cans contained therein. If the serial numbers run in consecutive order, only the first and last numbers need be shown on the fiberboard case.

SUBCHAPTER F.—BONDED AND TAXPAID WINE PREMISES

PART I.—ESTABLISHMENT

SECTION 5351.—BONDED WINE CELLAR

26 CFR 240.193: Designation as bonded winery. Rev. Rul. 56–10

Section 5351 of the Internal Revenue Code of 1954 provides that premises for the production, blending, cellar treatment, storage, bottling, packaging, or repackaging of untaxpaid wine shall be known as "bonded wine cellars" except that any such premises engaging in production operations may be designated as a "bonded winery." Section 240.193 of the Wine Regulations provides, in part, that if the activities to be conducted on the bonded wine cellar premises are such that a wine producer's basic permit is required under the Federal Alcohol Administration Act, a letter application, in triplicate, may be submitted with Form 698, Application by Proprietor of Bonded Wine Cellar or Bonded Winery, for designation of the premises as a bonded winery. *Held*, if the proprietor of a bonded wine cellar holds Form 1635, Wine Producer's and Blender's Basic Permit (Under the Federal Alcohol Administration Act and Regulations), and has produced wine within the past two years, a change in designation of the premises from bonded wine cellar to bonded winery may be approved by the Assistant Regional Commissioner, Alcohol and Tobacco Tax, upon receipt of a letter application filed pursuant to section 240.193 of the Wine Regulations. Approval of the application may be considered authority for changing the designation on all copies of Form 698. Consent of surety on Form 1533 to the change in designation of the premises should be filed.

SECTION 5352.—TAXPAID WINE BOTTLING HOUSE

26 CFR 231.30: General. Rev. Rul. 56–148

A rectifier producing a wine specialty under an approved formula may remove such product in bulk for bottling only at (1) another rectifying plant, (2) a taxpaid spirits bottling house, or (3) a taxpaid wine bottling house established and operated in conformity with the requirements of the Regulations relating to the Rectification of Spirits and Wines, the Regulations relating to Bottling of Taxpaid Spirits, and the Regulations relating to Taxpaid Wine Bottling Houses, respectively. In this connection, see Revenue Ruling 56–8, page 749 of this Bulletin, which provides in part that if taxpaid wine is to be bottled or rebottled on premises other than a rectifying plant or a taxpaid distilled spirits bottling house, a taxpaid wine bottling house must be established for such purpose pursuant to the requirements of section 5352 of the Internal Revenue Code of 1954.

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26 CFR 231.31: Use of taxpaid wine bottling house. Rev. Rul. 56–8

Section 5352 of the Internal Revenue Code of 1954 provides that any person bottling, packaging, or repackaging taxpaid wine at premises other than a rectifying plant or a taxpaid distilled spirits bottling house shall, before commencing such operations, make application and receive permission to operate a taxpaid wine bottling house. The term "bottling" as used therein is interpreted in section 231.31 of the Taxpaid Wine Bottling House Regulations to include the rebottling of wine. *Held*, liquor dealers, in their capacity as such, may not bottle or rebottle wine. If taxpaid wine is to be bottled or rebottled on premises other than a rectifying plant or a taxpaid distilled spirits bottling house, a taxpaid wine bottling house must be established for such operations, even though the operations are infrequent and small quantities of wine are involved. This ruling should not, however, be construed as prohibiting the bottling or rebottling on bonded wine cellar premises of taxpaid wine reconditioned on such premises.

PART II.—OPERATIONS

SECTION 5361.—BONDED WINE CELLAR OPERATIONS

26 CFR 240.132: Commercial fruit products and by-products. Rev. Rul. 56–201
(Also 240.890.)

Section 5361 of the Internal Revenue Code of 1954 authorizes, among other things, the preparation for market and storage of commercial fruit products and by-products not taxable as wine, and such other operations as may be conducted in a manner that will not jeopardize the revenue or conflict with wine operations, on bonded wine cellar premises. While sections 240.132 and 240.890 of the Wine Regulations, written pursuant to the above section of law, do not

specifically state that the bottling of vinegar is authorized, such operation is within the scope of the law and regulations. *Held*, the bottling on bonded wine cellar premises of vinegar produced by another manufacturer may be permitted, subject to the provisions of sections 240.890, 240.891, and 240.892 of the Wine Regulations.

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26 CFR 240.890: Application.

For bottling of vinegar produced by another manufacturer on bonded wine cellar premises, see Rev. Rul. 56–201, page 749.

SECTION 5362.—REMOVALS OF WINE FROM BONDED PREMISES

26 CFR 240.691: Reciprocating foreign countries.

The country of Lebanon has been added to the list of reciprocating foreign countries. See Rev. Rul. 56–81, page 746.

PART III.—CELLAR TREATMENT AND CLASSIFICATION OF WINE

SECTION 5382.—CELLAR TREATMENT OF NATURAL WINE

26 CFR 240.513: Statement of process for effervescent wine. Rev. Rul. 56–32

Section 240.513 of the Wine Regulations, which require the submission of a statement of process for effervescent wine, provides in part that where the proprietor of a bonded wine cellar has on file on the effective date of such regulations (January 1, 1955) approved formulas covering production of effervescent wine, new formulas need not be filed unless requested by the Assistant Regional Commissioner, Alcohol and Tobacco Tax. *Held*, although the Wine Regulations do not specifically provide for the use of syrup or sugar-water solution to develop secondary fermentation, winemakers having on file formulas for sparkling wines approved prior to January 1, 1955, which call for the use of syrup or sugar-water solution to develop secondary fermentation, need not be required to file new formulas under the provisions of section 240.513 of such regulations. The 60 degree minimum limitation as to the Balling of the sugar-water solution to be used for this purpose must be observed in such instances.

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26 CFR 240.529: Materials authorized for treatment of wine. Rev. Rul. 56–9

The use of Antifoam AF Emulsion to reduce the foam on wine in fermenters is considered as being consistent with good commercial

practice. Accordingly, such product may be approved for use by proprietors of bonded wine cellars within the general limitations of section 240.524 of the Wine Regulations.

Revenue Ruling 55–603, C. B. 1955–2, 709, contains a list of materials in addition to those authorized by section 240.529 of the Wine Regulations for use in the treatment of wine, is hereby modified to include Antifoam AF Emulsion.

Rev. Rul. 56–64

The use of a material identified as Sparkolloid No. 2 and conforming to the approved formula, in the proportion of two pounds per 1,000 gallons of wine, to clarify wine, is considered as being consistent with good commercial practice and is approved for use in the treatment of wine, within the general limitations of section 240.524 of the Wine Regulations. Accordingly, Revenue Ruling 55–603, C. B. 1955–2, 709, which contains a list of materials authorized for use in the treatment of wine, additional to those specifically covered by the Wine Regulations, is modified by changing the identification of the material listed therein as "Sparkolloid" to "Sparkolloid No. 1," and by adding thereto "Sparkolloid No. 2." See also Rev. Rul. 56–9, page 750 of this Bulletin.

Rev. Rul. 56–202

The use of ascorbic acid in the production of apple wine as a preservative to prevent deterioration of flavor and darkening of the color is considered as being consistent with good commercial practice. Accordingly, such product may be approved for use by proprietors of bonded wine cellars within the general limitations of section 240.524 of the Wine Regulations. It is understood that the Food and Drug Administration of the Department of Health, Education and Welfare requires that the use of ascorbic acid as a preservative be disclosed on the label.

Revenue Ruling 55–603, C. B. 1955–2, 709, which contains a list of materials, additional to those authorized by section 240.529 of the Wine Regulations, for use in the treatment of wine, is hereby modified to include the use of ascorbic acid in the production of apple wine. See also modification contained in Revenue Ruling 56–9, page 750, this Bulletin, and Revenue Ruling 56–64, page 751, this Bulletin.

SECTION 5386.—SPECIAL NATURAL WINES

26 CFR 240.445: Essences.

For instructions relative to the identification of essences listed as ingredients in special natural wine as shown on Form 698–Supplemental, see Rev. Proc. 56–15, page 1040.

SUBCHAPTER I.—MISCELLANEOUS GENERAL PROVISIONS

SECTION 5552.—INSTALLATION OF METERS, TANKS, AND OTHER APPARATUS

26 CFR 225.400: Kinds of containers. Rev. Rul. 56-203
(Also Part III-C, Section 5; FAA Regulations No. 5, Section 5.1.)

Wood is not considered a suitable material for the construction of storage tanks for the storage of brandies in an internal revenue bonded warehouse. However, oak ovals (casks or packages) are considered suitable containers for the packaging of brandy on which age may properly be claimed, provided such containers are of a capacity not exceeding 210 tax gallons.

Advice has been requested whether oak tanks or puncheons, from 100 to several thousand gallons in capacity, may be used in an internal revenue bonded warehouse for the storage and aging of brandy.

Under the law and regulations, containers used for the storage of brandy in bulk in an internal revenue bonded warehouse are restricted to (1) original packages filled in a distillery, (2) packages filled from storage tanks, and (3) storage tanks.

Since wood is not a suitable material for the construction of storage tanks under section 225.111 of the Regulations relating to the Warehousing of Distilled Spirits, oak ovals or puncheons can not be qualified as storage tanks.

Historically, casks or packages for the storage of distilled spirits range in capacity up to 210 tax gallons, as evidenced by tax stamps provided in the past for such packages. Age may be claimed on brandy stored in new or reused cooperage in accordance with the provisions of section 39(b) of the Regulations relating to the Labeling and Advertising of Distilled Spirits. Such authority does not extend to oak ovals of large capacity since the contact of the brandy with the wood surface would be too limited in comparison with the quantity of brandy for the brandy to obtain proper characteristics of age. Accordingly, oak ovals or puncheons (casks or packages), limited in capacity to not more than 210 tax gallons (or the equivalent of 210 wine gallons), may be used for storing brandy as original packages or packages filled from storage tanks. Where such containers are used, appropriate facilities must be provided for proper gauging and handling of the packages. Oak ovals of a capacity in excess of 210 tax gallons can not be used either as brandy storage tanks, or as original packages or packages filled from storage tanks.

SUBTITLE F.—PROCEDURE AND ADMINISTRATION

CHAPTER 80.—GENERAL RULES

SUBCHAPTER A.—APPLICATION OF INTERNAL REVENUE LAWS

SECTION 7805.—RULES AND REGULATIONS

26 CFR 182.630a: General. T. D. 6180[1]
(Also 225.860, 240.690, 245.290.)

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER E, PARTS 182, 225, 240, AND 245

Parts 182, 225, 240, and 245, of title 26 of the Code of Federal Regulations amended, in regard to supplies on vessels employed in the fisheries, to conform with Customs regulations.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On July 28, 1955, a notice of proposed rulemaking with respect to amendments of regulations in 26 CFR (1954) parts 182, 225, 240, and 245 was published in the Federal Register (20 F. R. 5398).

The purpose of the amendments is to conform 26 CFR (1954) parts 182, 225, 240, and 245 with the Bureau of Customs regulations, which have been amended by Treasury Decision 53935 (20 F. R. 8329), to clearly define the type of vessels employed in the fisheries which are entitled to withdraw distilled spirits, wines, or beer for use as supplies on such vessels. No data, views or arguments pertaining to these amendments having been received within the period of 30 days from the date of publication, 26 CFR (1954) parts 182, 225, 240, and 245 are amended, as follows:

PARAGRAPH 1. 26 CFR (1954) part 182, is amended as follows:

(A) Section 182.630a is amended as follows:

(1) By striking the word "Alcohol" from the first sentence and inserting in lieu thereof the words: "Subject to the applicable provisions of this part, alcohol".

(2) By striking from the statutory citations at the end of the section, references to "53 Stat. 360", and "3114", and inserting in lieu thereof "68A Stat. 655" and "5304", respectively.

(B) By inserting, immediately following § 182.630a, the following new section:

§ 182.630a–1 VESSELS EMPLOYED IN THE FISHERIES.—Alcohol may be withdrawn free of tax under the provisions of paragraphs (b) and (e) of § 182.630a relating to vessels employed in the fisheries, only for use on vessels of the United States documented to engage in the fisheries and foreign fishing vessels of 5 net tons or over if the Collector of Customs is satisfied by reason of the quantity requested in the light of (1) whether the vessel is employed in substantially con-

[1] 21 F. R. 3926.

tinuous fishing activities, and (2) the vessel's complement, that none of the withdrawn alcohol is intended to be removed from the vessel in, or otherwise returned to, the United States. Such shipment and lading shall be conditioned upon compliance with the applicable provisions of this part. Lading of such alcohol for use on such vessels shall be subject to approval by the collector of customs of a special written application, in duplicate, on customs Form 5125, of the exporter and designation by the applicant, in part 1 of the Form 1659 submitted to the Assistant Regional Commissioner for execution of the permit for removal and transportation of the alcohol, that the alcohol is to be laden for use as supplies on a vessel employed in the fisheries. The original application on customs Form 5125, after approval, shall be stamped with the withdrawal number (permit number on Form 1659) and date thereof and shall be returned by the collector of customs to the exporter for use as prescribed below. Approval of each such application shall be subject to the condition that the original shall be presented thereafter by the exporter or the vessel's master to the collector of customs within 24 hours (excluding any period during which the customhouse is not open for general customs business) after each subsequent arrival of the vessel at a customs port or station and that an accounting shall be made at the time of such presentation of the disposition of the alcohol until the collector of customs is satisfied that it has been consumed on board, or landed under customs supervision, and takes up the authorization. The approval of customs Form 5125 shall be subject to the further condition that any such withdrawn alcohol remaining on board while the vessel is in port shall be safeguarded in the manner and to such extent as the collector for the port or place of arrival shall deem necessary. When such alcohol has been accounted for to the satisfaction of the Collector of Customs, he shall so certify on the completed customs Form 5125 taken up from the exporter or the vessel's master and forward the form to the assistant regional commissioner for the region in which the premises from which the alcohol was withdrawn is located. In the event of a failure on the part of the exporter or the master of the vessel to comply with the conditions of the withdrawal or upon receipt of evidence that the alcohol was not lawfully used as supplies on the vessel, the collector of customs will advise the Assistant Regional Commissioner for the region in which the premises from which the alcohol was withdrawn is located of all the facts in the case for determination of any liability incurred. Assessment of tax liability found to have been incurred will be made against the principal on the bond. (46 Stat. 690, as amended; 19 U. S. C. 1309)

(C) Section 182.630d is amended by inserting in the third sentence of paragraph (a), which begins "Alcohol withdrawn for", immediately following the words "as required by", the following: "the applicable provisions of sections 182.630a–1,".

(D) Section 182.630j is amended as follows:

(1) By inserting, immediately following the first sentence, the following new sentence: "In the case of supplies on vessels employed in the fisheries, compliance with the provisions of § 182.630a–1 is required."

(2) By striking "§ 182.603" from the last sentence and inserting in lieu thereof the following: "§§ 182.603 and 182.630a–1".

(E) Section 182.630 1 is amended to read as follows:

§ 182.630 1 EVIDENCE OF USE ON VESSELS AND AIRCRAFT.—The principal on the bond shall also submit to the Assistant Regional Commissioner, within six months (or such additional time as may be granted by the Assistant Regional Commissioner) a statement of the master or other officer of the vessel or aircraft on which the alcohol was laden, having knowledge of the facts, showing that the alcohol has been used on board the vessel or aircraft, and that no portion thereof has been unladen in the United States or any of its territories or possessions: *Provided*, That such statement will not be required, in case of any shipment, when the alcohol is laden on vessels of war, or, in cases other than supplies on vessels employed in the fisheries, where the amount of tax on the alcohol does not exceed $100. Such statement shall be signed by the master or other officer having knowledge of the facts and immediately above the signature there will appear the following statement: "I declare under the penalties of perjury that this statement has been examined by me and to the best of my knowledge and belief is

true and correct:" and *Provided further*, That, in the case of vessels employed in the fisheries, in lieu of such statement, compliance with the provisions of § 182.630a–1 is required. (46 Stat. 690, as amended; 19 U. S. C. 1309.)

(F) Section 182.630m is amended by striking out the final period of the section and adding: ", except that, in the case of withdrawals for supplies on vessels employed in the fisheries, crediting of the bond will be subject to compliance with the provisions of § 182.630a–1."

PAR. 2 26 CFR (1954) part 225 is amended as follows:

(A) Section 225.860 is amended by striking the word "Distilled" from the first sentence and inserting in lieu thereof the words: "Subject to the applicable provisions of this part, distilled".

(B) By inserting, immediately following § 225.860, the following new section:

§ 225.860a VESSELS EMPLOYED IN THE FISHERIES.—Distilled spirits may be withdrawn free of tax under the provisions of paragraphs (b) and (e) of § 225.860, relating to vessels employed in the fisheries, only for use on vessels of the United States documented to engage in the fisheries and foreign fishing vessels of 5 net tons or over if the collector of customs is satisfied by reason of the quantity requested in the light of (1) whether the vessel is employed in substantially continuous fishing activities, and (2) the vessel's complement, that none of the withdrawn distilled spirits is intended to be removed from the vessel in, or otherwise returned to, the United States. Such shipment and lading shall be conditioned upon compliance with the applicable provisions of this part. Lading of such distilled spirits for use on such vessels shall be subject to approval by the collector of customs of a special written application, in duplicate, on customs Form 5125, of the exporter and designation by the applicant, in part 1 of the Form 206 submitted to the Assistant Regional Commissioner for execution of the permit for removal and transportation of the spirits, that the spirits are to be laden as supplies on a vessel employed in the fisheries. The original application on customs Form 5125, after approval, shall be stamped with the withdrawal number (serial number of Form 206) and date thereof and shall be returned by the collector of customs to the exporter for use as prescribed below. Approval of each such application shall be subject to the condition that the original shall be presented thereafter by the exporter or the vessel's master to the Collector of Customs within 24 hours (excluding any period during which the customhouse is not open for general customs business) after each subsequent arrival of the vessel at a customs port or station and that an accounting shall be made at the time of such presentation of the disposition of the spirits until the Collector of Customs is satisfied that all of them have been consumed on board, or landed under customs supervision, and takes up the authorization. The approval of customs Form 5125 shall be subject to the further condition that any such withdrawn spirits remaining on board while the vessel is in port shall be safeguarded in the manner and to such extent as the collector for the port or place of arrival shall deem necessary. When such spirits have been accounted for to the satisfaction of the Collector of Customs, he shall so certify on the completed customs Form 5125 taken up from the exporter or the vessel's master and forward the form to the Assistant Regional Commissioner for the region in which the warehouse from which the spirits were withdrawn is located. In the event of a failure on the part of the exporter or the master of the vessel to comply with the conditions of the withdrawal or upon receipt of evidence that the spirits were not lawfully used as supplies on the vessel, the Collector of Customs will advise the Assistant Regional Commissioner for the region in which the warehouse from which the spirits were withdrawn is located of all the facts in the case for determination of any liability incurred. Assessment of tax liability found to have been incurred will be made against the principal of the bond. (46 Stat. 690, as amended; 19 U. S. C. 1309.)

(C) Section 225.864 is amended by inserting in the list of sectional references in the second sentence, in its proper numerical sequence, a reference to section "225.860a."

(D) Section 225.865 is amended as follows:

(1) By inserting, in the Proviso of the first sentence, immediately following the words "vessels of war, or", the following:

", in cases other than supplies for vessels employed in the fisheries,".

(2) By inserting at the end of the section the following new sentence: "In the case of supplies for vessels employed in the fisheries compliance with the provisions of § 225.860a is required."

(E) Section 225.866 is amended by striking the period at the end of the fourth sentence, which begins "In the case of", and adding: ", except that credit will not be given in the case of withdrawals for supplies on vessels employed in the fisheries until the spirits are accounted for in conformity with the requirements of § 225.860a."

PAR. 3. 26 CFR (1954) part 240 is amended as follows:

(A) Section 240.690 is amended by striking "§ 240.691" from the first sentence, and inserting in lieu thereof: "§§ 240.690a and 240.691".

(B) By inserting immediately following § 240.690, the following new section:

§ 240.690a VESSELS EMPLOYED IN THE FISHERIES.—Wine may be withdrawn free of tax under the provisions of paragraph (b) and (e) of § 240.690 relating to vessels employed in the fisheries, only for use on vessels of the United States documented to engage in the fisheries and foreign fishing vessels of 5 net tons or over if the Collector of Customs is satisfied by reason of the quantity requested in the light of (1) whether the vessel is employed in substantially continuous fishing activities, and (2) the vessel's complement, that none of the withdrawn wine is intended to be removed from the vessel in, or otherwise returned to, the United States. Such shipment and lading shall be conditioned upon compliance with the applicable provisions of this part. Lading of such wine for use on such vessels shall be subject to approval by the collector of customs of a special written application, in duplicate, on customs Form 5125, of the exporter and designation by the applicant in part 1 of the Form 711–B submitted to the Assistant Regional Commissioner for approval of the removal of the wine, that the wine is to be laden for use as supplies on a vessel employed in the fisheries. The original application on customs Form 5125, after approval, shall be stamped with the withdrawal number (exporter's serial number on Form 711–B) and date thereof and shall be returned by the collector of customs to the exporter for use as prescribed below. Approval of each such application shall be subject to the condition that the original shall be presented thereafter by the exporter or the vessel's master to the Collector of Customs within 24 hours (excluding any period during which the customhouse is not open for general customs business) after each subsequent arrival of the vessel at a customs port or station and that an accounting shall be made at the time of such presentation of the disposition of the wine until the Collector of Customs is satisfied that it has been consumed on board, or landed under customs supervision, and takes up the authorization. The approval of customs Form 5125 shall be subject to the further condition that any such withdrawn wine remaining on board while the vessel is in port shall be safeguarded in the manner and to such extent as the collector for the port or place of arrival shall deem necessary. When such wine has been accounted for to the satisfaction of the collector of customs, he shall so certify on the completed customs Form 5125 taken up from the exporter or the vessel's master and forward the form to the Assistant Regional Commissioner for the region in which the bonded wine cellar from which the wine was withdrawn is located. In the event of a failure on the part of the exporter or the master of the vessel to comply with the conditions of the withdrawal or upon receipt of evidence that the wine was not lawfully used as supplies on the vessel, the collector of customs will advise the Assistant Regional Commissioner for the region in which the bonded wine cellar from which the wine was withdrawn is located of all the facts in the case for determination of any liability incurred. Assessment of tax liability found to have been incurred will be made against the principal on the bond. (68A Stat. 665; 26 U. S. C. 5362.)

(C) By inserting, immediately following § 240.701, the following new section:

§ 240.702 EVIDENCE OF USE ON VESSELS EMPLOYED IN THE FISHERIES.—In the case of wine laden for use on vessels employed in the fisheries, compliance with the provisions of § 240.690a is required. (68A Stat. 665; 26 U. S. C. 5362.)

PAR. 4. 26 CFR (1954) Part 245 is amended as follows:

(A) Section 245.290 is amended by striking the word "Beer" from the first sentence, and inserting in lieu thereof the words: "Subject to the applicable provisions of this subpart, beer".

(B) By inserting, immediately following § 245.290, the following new section:

§ 245.290a VESSELS EMPLOYED IN THE FISHERIES.—Beer may be withdrawn free of tax under the provisions of paragraphs (b) and (e) of § 245.290 relating to vessels employed in the fisheries, only for use on vessels of the United States documented to engage in the fisheries and foreign fishing vessels of 5 net tons or over if the Collector of Customs is satisfied by reason of the quantity requested in the light of (1) whether the vessel is employed in substantially continuous fishing activities, and (2) the vessel's complement, that none of the withdrawn beer is intended to be removed from the vessel in, or otherwise returned to, the United States. Such shipment and lading shall be conditioned upon compliance with the applicable provisions of this subpart. Lading of such beer for use on such vessels shall be subject to approval by the Collector of Customs, of a special written application, in duplicate, on customs Form 5125, of the exporter and designation by the applicant in part 1 of the notice, Form 1689, that the beer is to be laden for use as supplies on a vessel employed in the fisheries. The original application of customs Form 5125, after approval, shall be stamped with the withdrawal number (brewer's serial number on Form 1689) and date thereof and shall be returned by the Collector of Customs to the exporter for use as prescribed below. Approval of each such application shall be subject to the condition that the original shall be presented thereafter by the exporter or the vessel's master to the collector of customs within 24 hours (excluding any period during which the customhouse is not open for general customs business) after each subsequent arrival of the vessel at a customs port or station and that an accounting shall be made at the time of such presentation of the disposition of the beer until the Collector of Customs is satisfied that it has been consumed on board, or landed under customs supervision, and takes up the authorization. The approval of customs Form 5125 shall be subject to the further condition that any such withdrawn beer remaining on board while the vessel is in port shall be safeguarded in the manner and to such extent as the collector for the port or place of arrival shall deem necessary. When such beer has been accounted for to the satisfaction of the Collector of Customs, he shall so certify on the completed customs Form 5125 taken up from the exporter or the vessel's master and forward the form to the Assistant Regional Commissioner for the region in which the brewery from which the beer was withdrawn is located. In the event of a failure on the part of the exporter or the master of the vessel to comply with the conditions of the withdrawal, or on receipt of evidence that the beer was not lawfully used as supplies on the vessel, the collector of customs will advise the Assistant Regional Commissioner for the region in which the brewery from which the beer was withdrawn is located of all the facts in the case for determination of any liability incurred. Assessment of tax liability found to have been incurred will be made against the brewer. (68A Stat. 612; 26 U. S. C. 5053.)

(C) Section 245.294 is amended to read as follows:

§ 245.294 EVIDENCE OF LADING FOR USE.—When beer has been laden on board a vessel or aircraft for use as ship's supplies or supplies for aircraft, there must be submitted promptly to the Assistant Regional Commissioner a statement of the master or other officer of the vessel or aircraft on which the beer was laden, having knowledge of the facts, showing that the beer has been laden and will be used on board the vessel or aircraft, and that no portion thereof has been or will be unladen in the United States or any of its territories or possessions: *Provided*, That such statement will not be required, in the case of any shipment, where the beer has been laden on vessels of war, or, in cases other than supplies on vessels employed in the fisheries, where the amount of tax on the beer does not exceed $200. Such statement shall be signed by the master or other officer having knowledge of the facts and immediately above the signature there will appear the following statement: "I declare under the penalties of perjury that this statement has been examined by me and to the best of my knowledge and belief is true and correct." In the case of beer for use as supplies on vessels employed in the fisheries, compliance with the provisions of § 245.290a is required.

On receipt of a satisfactory statement (if required) and the original of customs Form 5125, bearing final certification by the Collector of Customs as to proper accounting of the beer (if required), the Assistant Regional Commissioner will enter proper credit in the export account. In the case of beer laden on vessels of war, or in cases other than supplies on vessels employed in the fisheries, where the amount of the tax on the beer does not exceed $200, credit will be given at the time of receipt of the certificate of inspection and lading executed by the inspector of customs, as provided in § 245.276. (68A Stat. 612; 26 U. S. C. 5053.)

The purpose of this Treasury Decision is to conform the applicable Internal Revenue Service regulations with Treasury Decision 53935 which amended Customs regulations to define the type of vessels engaged in the fisheries which are entitled to withdraw distilled spirits, wines, and beer for use as supplies. It is necessary that the regulations in 26 CFR parts 182, 225, 240, and 245 conform with the amended Customs regulations as early as possible. Inasmuch as Treasury Decision 53935 became effective November 5, 1955, it is hereby found that it is impracticable and contrary to the public interest to issue this Treasury Decision subject to the effective date limitation of section 4(c) of the Administrative Procedure Act (60 Stat. 238; 5 U. S. C. 1003(c)). Accordingly, this Treasury Decision shall be effective on the date of its publication in the Federal Register.

(This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U. S. C. 7805).)

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved May 31, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Published in the Federal Register June 8, 1956)

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26 CFR 220.60: Distillery buildings. T. D. 6159[1]
(Also 26 CFR 221.60, 225.117).

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER E, PARTS 220, 221, AND 225

Miscellaneous regulations

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On August 24, 1955, a notice of proposed rulemaking with respect to parts 220, 221 and 225 of title 26 (1954) of the Code of Federal Regulations was published in the Federal Register (20 F. R. 6156). The purpose of this proposal was to effect administrative decisions (1) to eliminate nighttime supervision of distilleries by storekeeper-gaugers except as may be made necessary by special processes such as the production of gin, (2) to transfer to distillers the responsibility for performing and recording certain entry gauges in the cistern

[1] 21 F. R. 176.

room, (3) to place with distillers responsibility for proper identification of spirits, (4) to provide that distillers shall furnish the storekeeper-gaugers in charge with advance schedules of planned operations, (5) to permit distillery equipment outside of a room or building, (6) to conform part 221 with the provisions of part 220 relating to conducting other businesses, (7) to permit, under restricted conditions, doors between distillery premises and off-premises rooms or buildings, (8) to eliminate requirements for weighing materials received (except when received in bond) and making a report of such receipts, (9) to provide for a volumetric gauge of spirits removed by pipeline to bonded premises operated by the distiller, or an affiliate or subsidiary of a distiller, (10) to eliminate the requirement for a special application to receive distilled spirits for redistillation and to provide that certain marks need not be placed on containers of distilled spirits removed to a contiguous premises for redistillation, (11) to provide for exportation of vodka and authorize the use of tank trucks, as well as tank cars, for exportation of distilled spirits, (12) to authorize the removal of fermented materials in connection with the conduct of other approved businesses, (13) to eliminate present requirements on distillers with respect to computing and reporting the calculated yield from distilling material, (14) to delete present requirements that distillers submit monthly reports of their operations on parts 1, 2, and 3 of Form 1598 or Form 15, as the case may be, and provide for the monthly report to be made on part 3 only of such forms, and to delete present requirements for reporting certain information on Form 15, (15) to permit the Government office for a distillery to be located on contiguous internal revenue bonded warehouse premises, (16) to authorize the approval of applications to transfer spirits in bond by the storekeeper-gauger at the shipping premises, (17) to authorize the storekeeper-gauger to approve applications on Form 206 to remove spirits for exportation, or to a customs manufacturing bonded warehouse, where the removal is made under a continuing bond, (18) to authorize the storekeeper-gauger to issue certificates of origin and age for spirits being exported, (19) to provide for the bottling of distilled spirits in bond for domestic use and for exportation from the same tank, (20) to provide a more flexible procedure for the withdrawal, without payment of tax, of distilled spirits for use on aircraft in international flights, (21) to provide that the assistant regional commissioners may authorize the leaving open of certain warehouse windows at other than regular business hours, (22) to authorize the mingling of neutral spirits in warehouse storage tanks, (23) to authorize storekeeper-gaugers to approve applications to rebottle, relabel, and restamp distilled spirits bottled in bond, (24) to correct discrepancies in part 225 with respect to specifications for fence foundations, the required number of copies of applications for changes in construction or in use of equipment, the procedure for submission of reports on Form 332, and to remove an erroneous reference to an obsolete part of a form, (25) to insert in warehouse regulations (part 225) instructions relative to addition of caramel to brandy at the warehouse which were formerly found in brandy regulations (part 221), (26) to correct an improper requirement in part 225 with respect to information to be effaced (by scraping or otherwise) from

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head of a barrel which is to be refilled from a gauge tank with same spirits, (27) to make optional with proprietors the marking of certain information on packages and barrels, (28) to remove certain administrative material for inclusion in internal management documents, and (29) to make technical changes of an editorial nature. After consideration of all such relevant matter as was presented by interested persons relating to the rules proposed, the amendments to 26 CFR (1954) Parts 220, 221 and 225 set forth below are hereby adopted.

PARAGRAPH 1. 26 CFR (1954) part 220, Production of Distilled Spirits, is amended as follows:

(A) Subpart D.—Construction, is amended to read as follows:

§ 220.60 DISTILLERY BUILDINGS.—Distillery buildings must be securely constructed of substantial materials and shall be so arranged and constructed as to afford adequate protection to the revenue and facilitate inspection by internal revenue officers: *Provided*, That the Assistant Regional Commissioner may, in his discretion, approve registered distilleries having equipment and apparatus, except as required by § 220.62, not located in a room or building, if, in his opinion, the location and construction are such that the revenue is not endangered and no additional supervision would be required. Except as otherwise provided in this part, distillery buildings must be completely separated from contiguous buildings not on the distillery premises by unbroken partitions of substantial construction extending from the ground to the roof in a direct vertical line. The Assistant Regional Commissioner may authorize communicating doors from distillery premises to an off-premises room or building when, in his opinion, such doors would not constitute a jeopardy to the revenue, but no such door leading to an internal revenue bonded warehouse shall be permitted nor shall such door be permitted in the cistern room. All outside doors of distillery buildings shall be equipped for locking with Government locks. Notwithstanding any other provision of this part, openings may be provided in roofs or outside walls of distillery buildings for safety equipment or for ventilating, lighting, or heating purposes. Such openings shall be equipped with substantial metal gratings, screens, or other protective devices when the Assistant Regional Commissioner determines that such devices are necessary for the protection of the revenue. Outside tanks used as receptacles for spirits, and stills and other equipment used for rectifying, purifying or refining the spirits must be enclosed and protected in the manner required by § 220.116a. Where equipment or apparatus is not located in a room or building, electric flood lights shall be installed for lighting the premises at night. Any other protective measures deemed essential by the Assistant Regional Commissioner may be required for distillery buildings or for equipment located within or without the distillery buildings.

§ 220.61 RECTIFYING ROOM.—Where distilled spirits are rectified, purified, or refined in the course of original and continuous distillation, and the apparatus or equipment used for the purpose is such that it cannot be securely locked, the distiller must provide a suitable rectifying room or building, or a fenced area conforming to the requirements of § 220.116a, in which shall be located such apparatus and equipment. Suitable tanks must be provided therein for the reception of spirits to be so treated. Where a rectifying room or building is provided it shall be constructed in accordance with the applicable provisions of § 220.62. No door, gate, window, or other opening (except necessary openings for approved pipelines) leading from the rectifying room, or fenced area, into any other building or area, except the distillery building or area, will be permitted. Each door or gate must be equipped with a substantial hasp and staple or other suitable facility for the reception of a Government lock. A sign will be placed over the entrance to the rectifying room or area bearing the words "Rectifying Room" or "Rectifying Area", as the case may be.

§ 220.62 CISTERN ROOM.—The distiller must provide a cistern room or building, in which shall be located the receiving cistern. The cistern room or building must be constructed of substantial materials. Where the floor, ceiling or walls are constructed of wood, the boards must be matched tongue and groove, except that wood floors may be of other than tongue and groove lumber if laid double with the second layer crossing the first at an angle of more than 20 degrees. Cistern room windows shall be substantially constructed and so ar-

ranged and equipped that they may be securely fastened on the inside. Cistern room windows which, because of their location with respect to the ground, a fire escape, roof, setback or balcony, create an additional jeopardy to the revenue, must be of the detention type or be protected by iron bars or solid shutters. Where solid shutters are provided they must be equipped for fastening on the inside with a Government lock or cap seal. Except as provided in § 220.64, no door, window, or other opening (except necessary openings for approved pipelines) leading into the distillery or into any other room or building will be permitted. The doors and other openings must lead into the yard connected with the distillery. All doors of the cistern room or building shall be equipped for locking on the inside with Government locks except the entrance door, which shall be equipped for locking on the outside with a Government seal lock. The cistern room must be well lighted and of sufficient size to permit the weighing, marking, and branding of the spirits to be done conveniently, and to accommodate the necessary equipment, including a desk and chairs for the use of internal revenue officers in preparing their reports. A sign must be placed over the entrance door of the cistern room bearing the words "Cistern Room". Where more than one cistern room is provided, each such room will be given an alphabetical designation as "A", "B", etc. (68A Stat. 628, 633; 26 U. S. C. 5173, 5192, 5193.)

§ 220.63 Temporary Storage Room.—Where spirits, after being drawn from the receiving cisterns into packages, are to be temporarily retained on the distillery premises pending tax-payment or removal for deposit in an internal revenue bonded warehouse off the distillery premises, as authorized by § 220.537, the distiller must provide a separate room in the cistern room for the temporary storage of such packages. The construction of such temporary storage room must conform to the provisions of this part governing the construction of the cistern room. The entrance door of the storage room shall open into the other part of the cistern room and be so constructed that it may be securely locked with a Government lock. Where another door is provided, it must lead into the yard connected with the distillery and be so constructed that it may be securely locked on the inside with a Government lock, and will be used for the removal of spirits temporarily stored in the room. If such other door is not provided, spirits may not be removed from the temporary storage room through the other portion of the cistern room while packages are being filled therein.

§ 220.64 Empty Container Storeroom.—If empty packages are to be stored on the distillery premises a separate room or building must be provided for such purpose. Such room or building shall not have any means of interior communication with any other room or building used in connection with the production or storage of distilled spirits: *Provided*, That the Assistant Regional Commissioner may authorize a door connecting with the cistern room when, in his opinion, such opening will not constitute a jeopardy to the revenue. Such door must be equipped for locking on the cistern room side with a Government lock. The empty container room or building may be used for general cooperage purposes.

§ 220.65 Government Office.—The distiller shall provide and maintain on the distillery premises, for the exclusive use of internal revenue officers, a securely constructed, well-lighted, heated, and ventillated office of suitable dimensions: *Provided*, That where the proprietor operates an internal revenue bonded warehouse on the same or contiguous premises, and a Government office conforming to the requirements specified in this section is provided on the warehouse premises, and such office is so located as to be suitable for the use of internal revenue officers assigned to the distillery, a separate Government office need not be provided on the distillery premises. The Government office shall be equipped with toilet and lavatory facilities, and with a suitable number of desks, chairs, file cases, and such other furniture as may be necessary for the keeping of records and the preparation of reports. The door of the Government office shall be equipped with a cylinder type lock and a sufficient number of keys therefor shall be furnished the Assistant Regional Commissioner for the use of internal revenue officers. Where deemed necessary to afford adequate security to Government property, the Assistant Regional Commissioner may require the windows of the Government office to be protected by shutters or iron bars, and the door to be so equipped that it may be securely fastened with a Government lock. A sign bearing the words "Government Office" must be placed over the entrance door.

§ 220.66 GOVERNMENT CABINET.—There shall be provided in the Government office a cabinet of adequate security and size, suitably equipped for locking with a Government seal lock, for use in safeguarding Government locks, keys, seals, and other Government property, and stamps in the custody of internal revenue officers. Each such cabinet shall be subject to approval by the Assistant Regional Commissioner.

(B) Section 220.100 is revoked.

(C) Section 220.101 is amended to read as follows:

§ 220.101 SCALES.—The distiller must provide in the cistern room suitable and accurate scales for weighing packages of distilled spirits. The distiller must also provide on the distillery premises suitable and accurate scales for the weighing of grain and other non-liquid distilling materials used. Beams or dials of scales used to weigh packages must indicate weight in half-pound graduations. (68A Stat. 639; 26 U. S. C. 5212)

(D) Section 220.102 is amended by striking from the first sentence the phrase "a weighing tank" and inserting in lieu thereof the word "tanks".

(E) Section 220.111 is amended by inserting at the end thereof the following new sentence:

The waste discharge line of every still, except those used for primary distillation of beer, must be secured to the sewer in such a manner as to preclude the recovery of distilled spirits from the waste discharge line: *Provided*, That where it is not practicable to secure such discharge lines to sewers, the Assistant Regional Commissioner may approve other construction, if he finds that such other construction will afford adequate protection.

(F) By inserting a new section, reading as follows, immediately after § 220.113:

§ 220.113a HIGH WINES, LOW WINES OR UNFINISHED SPIRITS TANKS.—(a) *General requirements.*—Where high wines, low wines, or unfinished spirits are produced, suitable tanks for the reception of such high wines, low wines, or unfinished spirits must be provided. The tanks shall be constructed and secured in conformity with the provisions of § 220.112, except that Government locks will not be required on the inlet or outlet valves. Each such tank shall have plainly and legibly painted thereon the words "High wine tank", "Low wine tank", or "Unfinished spirits tank", as the case may be, followed by its serial number and capacity in gallons. These tanks shall be connected with the inlets of the stills in which the spirits are to be redistilled, either directly or through the charge or feed tanks thereof, by means of pipelines constructed in accordance with the provisions of § 220.121. The pipelines connected with high wine, low wine, and unfinished spirits tanks shall be provided with valves to control the flow of spirits into and out of the tanks and such valves shall be so constructed that they may be closed and locked.

(b) *Special equipment.*—Where it is desired to reduce or scrub unfinished spirits before redistillation, there shall be permanently connected to the tank in which the spirits are reduced or scrubbed the necessary air and water lines. Such air and water lines shall be equipped with check valves located near the point of entry to the tank and the water lines shall be equipped with valves so arranged that they may be locked with Government locks: *Provided*, That if spirits are to be reduced during other than regularly assigned hours of supervision, the water lines shall not be equipped for locking but shall be equipped with metering or measuring devices by which the quantity of water added to a tank may be determined. If the distiller so desires, he may provide mechanical agitators in lieu of air lines. The introduction of any materials or substances into the tanks during other than regularly assigned hours of supervision must be accomplished by mechanical devices which effectively prevent the abstracting of spirits. Where the distiller desires to charge pot or kettle stills during other than regularly assigned hours of supervision, he must provide such measuring devices as may be necessary to determine the quantity of spirits withdrawn from the tanks. If the distiller desires to withdraw samples from the tanks, it will be necessary that he install sampling devices unless authority to withdraw the samples under supervision has been given pursuant to § 220.484. (68A Stat. 628, 680; 26 U. S. C. 5173, 5552.)

(G) The headnote to § 220.114 is changed to read: "TANKS FOR RETENTION OF UNFINISHED SPIRITS DURING ALTERNATE OPERATIONS."

(H) By inserting a new section, reading as follows, immediately after § 220.116:

§ 220.116a OUTSIDE TANKS, STILLS AND RECTIFYING EQUIPMENT.—Tanks used as receptacles for spirits, stills and rectifying equipment which, pursuant to § 220.60, are not located within a building, shall conform to the requirements of this section in addition to other applicable provisions of this part. The equipment shall be erected on a solid concrete base or foundation and all tanks shall be of substantial metal construction. The tanks, stills and rectifying equipment shall be completely enclosed by a fence extending to a height of at least ten feet above the ground, constructed of not less than No. 6 gauge, nor more than 2-inch mesh, expanded metal or woven wire, with at least three rows of barbed wire superimposed on the top thereof. The fence posts shall be made of iron or steel, imbedded securely in a continuous concrete foundation which shall be at least twelve inches thick, and extend not less than eighteen inches below the ground. A suitable gate in such fence shall be provided, which gate shall be of equal security and shall be equipped with a hasp and staple for the reception of a lock. Pipelines to and from the equipment shall conform to the requirements of § 220.121. The Assistant Regional Commissioner may require, in any case in which he deems necessary, in addition to the installation of electric flood lights for lighting the enclosure as required by § 220.60, the maintenance of watchman service, or other protective measures or devices. (68A Stat. 628; 26 U. S. C. 5173.)

(I) Section 220.118 is amended by striking from the second sentence the figures "220.74" and inserting in lieu thereof the figures "220.61."

(J) Section 220.119 is amended as follows:

(1) By striking the second sentence, which begins "The adequacy of".

(2) By changing the fourth sentence to read, "Each receiving cistern must be equipped with a suitable measuring device, such as an etched gauge glass, or other equally accurate gauge device whereby the actual contents will be correctly indicated and shall have plainly and legibly painted thereon the words, "Receiving Cistern" followed by its serial number and capacity in gallons.

(3) By inserting, immediately after the fourth sentence, a new sentence, "Where gauge glasses are used provision must be made to exhaust or flush the glasses so they will accurately reflect the contents of the cisterns."

(4) By inserting, immediately after the eighth sentence, which begins, "Pipe lines connected", a new sentence, "The inlet to each cistern shall be equipped with a valve located in close proximity to the cistern and so arranged that it may be locked with a Government lock."

(5) By inserting at the end of the section a new sentence, "No receiving cistern shall be used until it has been calibrated or, in the case of existing cisterns, recalibrated, and approved by an internal revenue officer, and a certificate, Form 244, has been attached thereto as provided in § 220.303a."

(K) Section 220.120 is amended by placing a period after the phrase "any of the cisterns" in the first sentence and striking the remainder of the section.

(L) Section 220.249 is amended as follows:

(1) By striking from the headnote the words "Materials and".

(2) By striking from the first sentence the phrase "distilling materials" and inserting in lieu thereof "mash, beer".

(3) By striking from the second sentence the phrase "If the unfinished spirits and distilling materials" and inserting in lieu thereof "If the mash, beer, and unfinished spirits".

(M) Section 220.258 is amended to read as follows:

§ 220.258 MASH, BEER, AND UNFINISHED SPIRITS.—If mash, beer, and unfinished spirits are received by transfer from the predecessor, the successor must comply with the requirements of Subpart BB of this part.

(N) Section 220.280 is amended by changing paragraph (c) to read as follows:

(c) *Mash, beer, and unfinished spirits.*—If mash, beer, and unfinished spirits are to be transferred to the successor, comply with the requirements of §§ 220.720, 220.721 and 220.723. Whenever the proprietorship is to be alternated after the first suspension, the procedure prescribed in §§ 220.282 and 220.283 will be followed.

(O) Section 220.282 is amended by changing paragraph (b) to read as follows:

(b) *Mash, beer, and unfinished spirits.*—If mash, beer, and unfinished spirits are to be transferred to the successor, the procedure prescribed by §§ 220.720, 220.721 and 220.723 must be followed, except that Form 1614 will be filed with the storekeeper-gauger in charge.

(P) Section 220.283 is amended by changing paragraph (b) to read as follows:

(b) *Mash, beer, and unfinished spirits.*—If mash, beer, and unfinished spirits are to be received from the predecessor, the procedure prescribed by §§ 220.720, 220.721 and 220.723 will be followed, except that Form 1614 will be filed with the storekeeper-gauger in charge.

(Q) Section 220.290 is amended by changing paragraph (c) to read as follows:

(c) *Mash, beer, heads and tails, and unfinished spirits.*—If mash and beer are transferred to the successor or if heads aind tails or unfinished spirits are to be retained on the premises pending the resumption of operations as a registered distillery, comply with the requirements of §§ 220.706–220.710. Whenever alternate operations are to be conducted after the first suspension, the procedure prescribed by §§ 220.292 and 220.293 will be followed.

(R) Section 220.292 is amended by changing paragraph (b) to read as follows:

(b) *Mash, beer, heads and tails, and unfinished spirits.*—If mash and beer are transferred to the successor or if heads and tails or unfinished spirits are to be retained on the premises pending the resumption of operations as a registered distillery, comply with the requirements of §§ 220.707, 220.708, and 220.710.

(S) Section 220.293 is amended by changing paragraph (b) to read as follows:

(b) *Materials.*—If mash or beer are received by transfer from the predecessor, comply with the requirements of §§ 220.709 and 220.710.

(T) By inserting a new section, reading as follows, immediately after § 220.303:

§ 220.303a. APPROVAL OF RECEIVING CISTERNS.—When the officer who is required to examine the receiving cisterns is satisfied that the same are properly constructed, and that the gauge glasses or other gauge devices are accurate, he will so report to the Assistant Regional Commissioner, in writing, and will securely attach to the receiving cistern a certificate on Form 244.

(U) By inserting a new section, reading as follows, immediately after § 220.366:

§ 220.366a DISTILLER'S SCHEDULE OF OPERATIONS.—The distiller shall furnish daily to the storekeeper-gauger in charge a schedule of operations for the next succeeding work day. This schedule shall show all activities which require the immediate supervision or attention of a storekeeper-gauger, such as, the quantity and kind of spirits to be received for redistillation, cistern room operations, including the approximate number of packages to be gauged either for taxpayer or for deposit (with notations as to any packages intended for subsequent withdrawal on the original gauge), as well as the anticipated removals by pipeline or by tank car or tank truck, and schedules repairs which will involve the breaking or replacing of seals or the manipulation of Government locks.

(V) Section 220.367 is amended to read as follows:

§ 220.367 RECEIPT OF MATERIALS.—The distiller shall maintain a record of all distilling materials received on the distillery premises, showing the date of receipt, the name of the person from whom received, and the kind and quantity of each material received. Where commercial invoices or bills of lading contain the required information, a separate record will not be required. Such record, commercial invoices or bills of lading shall be kept available for inspection by internal revenue officers at all times during regular business hours. (68A Stat. 637; 26 U. S. C. 5197.)

(W) Section 220.379 is amended as follows:

(1) By inserting immediately after the first sentence the following new sentences:

Where two or more types of mash are produced or processed in the same month, a separate page of part 1 of Form 1598 shall be used to report each type of mash. Each page shall bear a notation identifying the type of mash reported thereon.

(2) By striking the second, third and fourth sentences.

(X) Section 220.390 is revoked.

(Y) Section 220.391 is amended as follows:

(1) By striking from the second sentence, which begins "The doors", the words "in the presence of the storekeeper-gauger".

(2) By striking from the third sentence, which begins "The entrance door", the figures "220.75" and inserting in lieu thereof the figures "220.62".

(3) By inserting immediately after the third sentence the following new sentence: "The valves on the inlets of receiving cisterns must be closed and locked prior to gauge of the spirits therein for withdrawal and shall remain locked until the withdrawal is completed."

(4) By changing the fourth sentence, which begins, "The openings in", to read: "All other openings in receiving cisterns will be kept locked at all times, except the outlets of cisterns being emptied, and the manheads when spirits are being agitated and reduced preparatory to withdrawal."

(5) By changing the fifth sentence, which begins, "The cistern room", to read: "The keys to the Government locks will not be intrusted at any time to the distiller or any person in his employ, but will be retained at all times in the possession of the designated storekeeper-gauger."

(Z) Section 220.435 is amended by striking the third, fourth and fifth sentences.

(AA) Section 220.445 is amended as follows:

(1) By changing the first sentence to read, "Distilled spirits may be received at the distillery for redistillation after the distiller has given notice, in duplicate, to the Assistant Regional Commissioner."

(2) By striking from the third sentence, which begins, "Spirits received", the words "a Government" and inserting in lieu thereof the words "an internal revenue".

(BB) Section 220.446 is revoked.

(CC) Section 220.447 is amended to read as follows:

§ 220.447 ACTION BY ASSISTANT REGIONAL COMMISSIONER.—Upon receipt of a notice of intent to receive spirits for redistillation, the Assistant Regional Commissioner will note the penal sum of the distiller's bond on all copies of the notice, retain one copy, and furnish one copy to the storekeeper-gauger in charge at the distiller's premises. The Assistant Regional Commissioner will advise the storekeeper-gauger of any subsequent change in the penal sum of the distiller's bond. (68A Stat. 634; 26 U. S. C. 5194.)

(DD) Section 220.448 is amended as follows:

(1) By striking the first and second sentences and inserting in lieu thereof the following new sentence, "When the distiller desires to receive spirits for redistillation, he shall prepare Form 236, properly modified for that purpose, covering the transfer of such spirits."

(2) By striking the third sentence, which begins "Where the consignor", and inserting in lieu therof the following new sentences:

Where the consignor distillery or warehouse is located in the same region, an original and five copies of the Form 236 will be prepared and delivered to the storekeeper-gauger. An original and six copies of the form will be prepared if the consignor distillery or warehouse is located in a different region.

(3) By striking the fourth sentence, which begins, "The storekeeper-gauger will", and inserting in lieu the following new sentence: "If the storekeeper-gauger finds that the penal sum of the distiller's bond is sufficient to cover the redistillation of the spirits described therein, he will execute a certificate on all copies of Form 236 and return all of the copies to the distiller."

(4) By striking from the fifth sentence, which begins, "The distiller will", the phrase "and one copy of the approved special application".

(EE) Section 220.451 is amended as follows:

(1) By inserting, immediately after the first sentence, the following new sentence: "Spirits for redistillation shall be transferred to the fermenters or beer well or introduced into tanks in the distilling system only during the hours of regularly assigned supervision."

(2) By striking the third and fourth sentences, which begin "Where spirits received" and "Where such spirits", respectively.

(FF) Section 220.453 is amended by striking the second sentence, which begins "Where such spirits".

(GG) Section 220.454 is amended to read as follows:

§ 220.454 GAUGE OF SPIRITS.—Upon receipt of application, Form 236, the distiller, when he desires to make shipment, will give a copy of Form 236 to the storekeeper-gauger and furnish a complete description of the spirits to be shipped. Where the spirits are removed by pipeline to a contiguous distillery, they may be gauged in weighing tanks either before removal or upon receipt: *Provided*, That where the spirits are removed to a contiguous distillery operated by the same distiller, or an affiliate or subsidiary of the distiller, they may be gauged by volume in accurately calibrated tanks in the cistern room of the transferring distiller. The storekeeper-gauger will verify the distiller's gauge as provided in § 220.536. The distiller will prepare his report of gauge on Form 1520. An original and 4 copies wil be prepared for intraregion shipments and an original and 5 copies for interregion shipments. The marking of containers will be made in accordance with § 220.545 insofar as applicable, and, in addition to required transfer-in-bond markings for containers of spirits removed for redistillation, there will be stenciled thereon the words, "For redistillation": *Provided*, That where containers of spirits are removed to a contiguous distillery for prompt redistillation, the transfer-in-bond markings and the words "For Redistillation" need not be placed on the containers. The distiller will note on all gauge reports covering removal of spirits for redistillation the words, "For Redistillation." Forms 236 and 1520 will be disposed of in accordance with § 220.611 for intraregion transfers and § 220.619 for interregion transfers. (68A Stat. 634; 26 U. S. C. 5194.)

(HH) Section 220.455 is amended by changing the comma following the phrase "'For Redistillation'" in the second sentence to a period and striking the remainder of the sentence.

(II) Section 220.480 is amended as follows:

(1) By striking the phrase "three pints" where it appears in paragraphs (a) and (b) and inserting in lieu thereof the phrase "two quarts".

(2) By striking from the first sentence in paragraph (d) the phrase "during specified periods,".

(3) By striking from the second sentence of paragraph (d) the phrase "of such samples shall not exceed one quart,".

(JJ) Section 220.484 is amended as follows:

(1) By changing the headnote to read, "*Taking of samples.*".

(2) By striking from the first sentence the phrase "and unfinished spirits must be taken under the immediate supervision of the storekeeper-gauger except that samples of unfinished spirits may be taken" and inserting in lieu thereof the following, "spirits must be taken under the supervision of the storekeeper-gauger. Samples of unfinished spirits, including those from tanks, shall be taken".

(3) By changing the period at the end of the last sentence to a colon and adding the following: *Provided*, That where new equipment is being tested, the storekeeper-gauger may supervise the taking of samples of unfinished spirits: *Provided further*, That the Assistant Regional Commissioner may, on receipt of written application by the distiller, authorize the storekeeper-gauger to regularly supervise the taking of samples of unfinished spirits from tanks. No application to regularly take samples of unfinished spirits from tanks under supervision, rather than by sampling devices, shall be approved unless it is shown by the distiller that such procedure would not be burdensome and that requests for supervision of such sampling would be made only at such time as the storekeeper-gauger is free from other supervisory duties.

(KK) Section 220.488 is amended by changing the first sentence to read, "The storekeeper-gauger shall keep on Form 1615, in quadruplicate, a record of all taxable samples removed."

(LL) Section 220.501a is amended by inserting, immediately after the phrase "in tank cars", the phrase "or tank trucks".

(MM) Section 220.505 is amended by inserting in the first sentence, immediately after the phrase "in tank cars", the phrase "or tank trucks".

(NN) Section 220.510 is amended by inserting, immediately after the phrase "in tank cars", the phrase "or tank trucks".

(OO) Section 220.514 is amended by inserting, immediately after the phrase "in tank cars", the phrase "or tank trucks".

(PP) Section 220.518 is amended by inserting, immediately after the phrase "in tank cars", the phrase "or tank trucks".

(QQ) Section 220.522 is amended by inserting in the first sentence, immediately after the phrase "in tank cars", the phrase "or tank trucks".

(RR) By inserting a new section, reading as follows, immediately after § 220.525:

§ 220.525a EXPORTS.—Vodka of any proof may be removed in tank cars or tank trucks, free of tax, for exportation. Vodka of any proof may be removed to an internal revenue bonded warehouse in wooden packages, each containing two or more metallic cans having a capacity of not less than five wine gallons each, for exportation only. (68A Stat. 633, 647; 26 U. S. C. 5193, 5247.)

(SS) Section 220.531 is amended by striking from the last sentence the phrase "to be marked on the empty" and inserting in lieu thereof the phrase "of the".

(TT) Section 220.533 is amended by inserting in the first sentence, immediately following the phrase "the date of filing, and" the phrase "), except as provided in § 220.546a,".

(UU) Section 220.536 is amended as follows:

(1) By inserting, immediately after the headnote, the following new sentence:

All distilled spirits drawn from receiving cisterns (a) for taxpayment and removal by pipeline or in tank cars or tank trucks, or (b) into packages which are to be taxpaid immediately from the cistern room or from a temporary storage room within the cistern room, or (c) into packages, tank cars, or tank trucks, which are to be withdrawn on the original gauge from any internal revenue bonded warehouse, or (d) into tank cars or tank trucks for exportation, shall be carefully gauged by the storekeeper-gauger, who will also record the details of the gauge and other required information on the report of gauge, Form 1520.

(2) By striking the first sentence and inserting in lieu thereof the following new sentences:

Distilled spirits drawn from receiving cisterns for all other purposes will be carefully gauged by the distiller, under the supervision of the storekeeper-gauger, by weighing, except as provided by § 220.538, and proofing the spirits in accordance with this subpart and the Gauging Manual (Part 186 of this title), and the details thereof will be entered by the distiller on the report of gauge, Form 1520. The total number of barrels shown on Form 1520 to have been filled shall be verified.

(3) By inserting, immediately after the first sentence the following new sentences:

The storekeeper-gauger shall in every instance verify the proof (before and after reduction) of the spirits in the cistern and determine, either by weight

or by volume, the contents of each cistern before and after any spirits are withdrawn therefrom. Where spirits are gauged by the distiller for removal in tank cars, tank trucks, or by pipeline, the storekeeper-gauger shall personally verify the net weight or wine gallons, proof, and tax gallons and enter his name and title on all copies of Form 1520.

(4) By inserting in the second sentence, immediately after the word "Entries", the words "on Form 1520".

(5) By changing the third sentence to read, "The proof of distillation of the spirits gauged shall be noted on the Form 1520 in every instance."

(6) By striking from the fourth sentence, which begins "The proof of", the word "being" and inserting in lieu thereof the phrase "the spirits are".

(7) By striking from the seventh sentence, which begins "Where the proof", the phrase "this title (Gauging Manual)" and inserting in lieu thereof the phrase "the Gauging Manual".

(8) By striking from the ninth sentence, which begins "In any such case", the phrase "shall made notation on Form 1520 that the spirits were reduced to a whole degree of proof or, if they were not so adjusted, the fractional degree of proof at which withdrawn." and inserting in lieu thereof the phrase "shall show on Form 1520 the whole or fractional degree of proof at which the spirits are withdrawn."

(9) By striking from the last sentence the phrases "for shipment" and "in a weighing tank".

(VV) By inserting two new sections, reading as follows, immediately after § 220.536:

§ 220.536a STOREKEEPER-GAUGER TO CHECK DISTILLER'S GAUGE.—In every instance where the removal gauge of spirits is performed and reported by the distiller, the storekeeper-gauger shall compare his determination of the total quantity withdrawn from the receiving cistern with the total quantity reported as withdrawn by the distiller and where the spirits are drawn into packages the storekeeper-gauger shall also, from time to time, verify the tares, proofs, gross weights, and tax gallonages as determined by the distiller. Where the storekeeper-gauger finds, as the result of his sampling of a gauge made by the distiller, or upon comparing his gauge of a receiving cistern with the total reported withdrawn by the distiller, significant discrepancies in the distiller's entry record, or the marks and brands required to be placed on any container, the distiller shall make such corrections of the gauge, the entry record, and the marks and brands as may be required by the storekeeper-gauger to insure that the gauge, the entry record, and the marks and brands are correct. (68A Stat. 633, 639; 26 U. S. C. 5192, 5193, 5212.)

§ 220.536b ENTRY FOR SUBSEQUENT WITHDRAWAL ON ORIGINAL GAUGE.—Where the distiller desires to draw spirits from receiving cisterns for entry into an internal revenue bonded warehouse and subsequent withdrawal on the original gauge, he shall notify the storekeeper-gauger of such intention in writing in order that the gauge and report of such spirits may be made by the storekeeper-gauger. The notice, which shall be prepared on the distiller's letterhead, and be signed by the distiller or a designated attorney-in-fact, shall contain the following information:

(a) A statement that the distilled spirits identified therein are to be entered for deposit and subsequent withdrawal on the original gauge;

(b) The registry number and location of the warehouse in which the distilled spirits are to be entered;

(c) The kind of distilled spirits;

(d) The proof of distillation;

(e) The kind of cooperage, or, if not to be packaged, the means of removal; and

(f) The approximate quantity to be removed. The storekeeper-gauger will note on all copies of Form 1520 covering the gauge of such spirits,

"withdraw on original gauge." The notice will be securely attached to the copy of the Form 1520 retained by the storekeeper-gauger at the distillery. (68A Stat. 633, 634, 639, 647; 26 U. S. C. 5193, 5194, 5212, 5245.)

(WW) Section 220.537 is amended by striking from the first sentence reference to "§ 220.76" and inserting in lieu thereof "§ 220.62".

(XX) Section 220.538 is amended as follows:

(1) By inserting in the first sentence, immediately after the phrase "operated by the distiller," the phrase "or an affiliate or subsidiary of the distiller,".

(2) By changing the period at the end of the first sentence to a comma and adding the following, "or they may be gauged by volume in accurately calibrated tanks in the cistern room of the transferring distiller."

(3) By striking the second sentence.

(4) By striking from the last sentence the phrase "by the storekeeper-gauger".

(YY) Section 220.544 is amended to read as follows:

§ 220.544 GENERAL.—Any cask or package which contains or has on its interior or exterior any substance that will prevent the correct ascertainment of tare shall not be used. The tare or weight of empty packages will be determined immediately prior to filling by the person responsible for the gauge: *Provided*, That the tare of a number of packages may be ascertained and marked thereon before any are filled out but not exceeding the number which are to be filled the same or the following day. If the packages are not to be filled until the following day, they must be locked in the cistern room after being weighed. Whenever there is a change in the specifications as to capacity and weight of cooperage, the distiller shall give notice to the storekeeper-gauger. All packages of spirits, when filled, shall be further marked and branded as provided by this subpart, and where such packages are taxpaid, the prescribed stamps will be affixed thereto and canceled in the manner prescribed in § 220.567. (68A Stat. 633, 634, 639; 26 U. S. C. 5192, 5193, 5194, 5212.)

(ZZ) Section 220.545 is amended as follows:

(1) By striking the first sentence of paragraph (a) and inserting in lieu thereof the following new sentences:

There shall be marked on the head of each package the name of the distiller or the person in whose name the spirits were produced, the registry number of the distillery, the city or town and state in which the distillery is located, the kind of cooperage, the serial number of the package, the kind of spirits, the date of filling, the proof at which distilled, and, except as provided in § 220.546a, the original proof gallons, the original proof and tare determined at the time of filling. If packages are taxpaid in the cistern room, the date of taxpayment and serial number of the wholesale liquor dealer's stamp shall also be marked on the head of each package.

(2) By striking from the third sentence of paragraph (d), which begins "The proof,", the phrase "proof gallons, tare and withdrawal data," and inserting in lieu thereof the phrase "proof gallons, and tare (where used), and withdrawal data,".

(AAA) By inserting a new section, reading as follows, immediately after § 220.546:

§ 220.546a OPTIONAL MARKING.—The markings on packages and barrels with respect to proof, proof gallons and tare which are required and illustrated in §§ 220.533, 220.545 and 220.546 may, at the option of the distiller, be omitted from the package or barrel if such package or barrel is filled to capacity and if there is shown in lieu of such markings the rated capacity, in gallons, of the package or barrel as prescribed by the manufacturing specifications. Where used, the rated capacity shall be in letters and figures not less than one-half inch in height and may be shown on "RC——G." (68A Stat. 633; 26 U. S. C. 5193)

(BBB) By inserting a new section, reading as follows, immediately preceding § 220.556:

§ 220.555a PRODUCT IDENTIFICATION.—The distiller shall be responsible for correctly identifying spirits at the time of their gauge for removal from the cistern room and for the accuracy of prescribed marks and brands. (68A Stat. 633, 364; 26 U. S. C. 5193, 5194)

(CCC) Section 220.557 is amended by striking from the last sentence the phrase "expect the instruments for proofing the spirits".

(DDD) Section 220.558 is amended to read as follows:

§ 220.558 TESTING OF SCALES.—The storekeeper-gauger shall balance the scales before the weighing of packages, either empty or filled, is commenced, and will frequently test the accuracy of such scales by means of test weights provided in accordance with § 220.104. The storekeeper-gauger will not permit the use of any scales which upon testing are found to be inaccurate. (68A Stat. 639; 26 U. S. C. 5212.)

(EEE) Section 220.559 is amended as follows:

(1) By inserting, immediately after the headnote the following new sentence, "The proof of spirits shall be determined in accordance with the instructions set forth in the Gauging Manual (part 186 of this title)."

(2) By changing the first sentence to read, "The storekeeper-gauger shall determine, or verify, as the case may be, the proof of all spirits gauged."

(3) By striking the second sentence, which begins, "The storekeeper-gauger will".

(FFF) Section 220.560 is revoked.

(GGG) Section 220.589 is amended as follows:

(1) By changing the first sentence to read, "Where the distiller operates an internal revenue bonded warehouse on the distillery premises and spirits produced at the distillery are to be entered for deposit in such warehouse, the spirits shall, as authorized by §§ 220.500–220.526, be drawn into approved containers, gauged, marked, and branded, and then immediately deposited in such warehouse, or, in the case of pipeline transfers, gauged and deposited in the warehouse tanks in the manner provided in § 220.538."

(2) By striking from the second sentence the word "immediate".

(3) By inserting in the third sentence, immediately after the words "The storekeeper-gauger", the words, "or distiller, as required by § 220.536,".

(4) By changing the last sentence to read, "On completion of the form, the distiller will execute his entry of the spirits for deposit."

(HHH) Section 220.593 is amended as follows:

(1) By striking the third sentence, which begins, "The storekeeper-gauger".

(2) By striking from the last sentence the word "direct".

(III) A new section, reading as follows, is inserted immediately after § 220.596:

§ 220.596a FORMS 236 ORIGINATING AT CONSIGNOR PREMISES.—Where spirits are to be transferred to and entered for deposit in an internal revenue bonded

warehouse operated by the distiller, or an affiliate or subsidiary of the distiller, in the same region and the receiving warehouse has on file a bond in the maximum penal sum of $200,000, the consignee warehouseman may designate an agent or employee of the consignor distiller as an attorney-in-fact to execute Form 236 for the consignee warehouseman. The consignee warehouseman shall file letter application with the Assistant Regional Commissioner for permission to establish such procedure, together with power of attorney on Form 1534, in triplicate, executed as provided in § 220.166, authorizing an individual at the consignor premises to execute Form 236 for the consignee warehouseman. If the Assistant Regional Commissioner approves the application, he shall so notify the applicant and furnish the storekeeper-gauger in charge at the consignor premises a copy of the approved Form 1534 on which he has noted the fact that the consignee warehouse has on file a bond in the maximum penal sum. The Assistant Regional Commissioner will advise the storekeeper-gauger of any subsequent change in the penal sum of the consignee's bond. The designated attorney-in-fact may thereafter execute Forms 236 covering transfers to the designated warehouse in the manner provided in § 220.595 and the storekeeper-gauger in charge at the distillery may approve such Forms 236.

(JJJ) Section 220.598 is amended by inserting in the last sentence, immediately after the phrase "the storekeeper-gauger", the phrase "or distiller, as required by § 220.536,".

(KKK) Section 220.606 is amended by striking the phrase "Upon receiving an order to gauge spirits to be" and inserting in lieu thereof the phrase "When spirits are to be".

(LLL) Section 220.607 is amended as follows:

(1) By striking from the first sentence the phrase "in the immediate presence" and inserting in lieu thereof the phrase "under the supervision".

(2) By striking the second and third sentences.

(3) By striking from the fourth sentence, which begins "The officer", the phrase "officer will enter on Form 1520, covering the gauge of the spirits, the".

(4) By inserting in the fourth sentence, immediately after the phrase "spirits at filling", the phrase "will be entered on Form 1520".

(5) By striking the fifth sentence, which begins "The storekeeper-gauger", and inserting in lieu thereof the following new sentence, "The storekeeper-gauger will seal the tank car or tank truck as soon as it is filled and will note on Form 236 the serial numbers of the seals used."

(6) By striking from the sixth sentence, which begins "In the case of", the phrase "he will also enter" and inserting in lieu thereof the phrase "the storekeeper-gauger will enter".

(MMM) By inserting a new section, reading as follows, immediately after § 220.613:

§ 220.613a FORMS 236 ORIGINATING AT CONSIGNOR PREMISES.—Where spirits are to be transferred to and entered for deposit in an internal revenue bonded warehouse operated by the distiller, or an affiliate or subsidiary of the distiller located in a different region and the receiving warehouse has on file a bond in the maximum penal sum of $200,000, the consignee warehouseman may designate an agent or employee of the consignor distiller as an attorney-in-fact to execute Form 236 for the consignee warehouseman. The consignee warehouseman shall file letter application with the Assistant Regional Commissioner for permission to establish such procedure, together with power of attorney on Form 1534, in quadruplicate, executed as provided in § 220.166, authorizing an individual at the consignor premises to execute Form 236 for the consignee warehouseman. If the Assistant Regional Commissioner approves the application, he shall so notify the applicant and furnish the Assistant Regional Commissioner

of the region in which the consignor distillery is located two copies of the approved Form 1534 on which he has noted the fact that the consignee warehouse has on file a bond in the maximum penal sum. The Assistant Regional Commissioner for the consignee premises will advise the Assistant Regional Commissioner for the consignor premises of any subsequent change in the penal sum of the consignee's bond. The Assistant Regional Commissioner of the consignor premises shall furnish one copy of the approved Form 1534 to the storekeeper-gauger at the consignor premises. The designated attorney-in-fact may thereafter execute Forms 236 covering transfers to the designated warehouse in the manner provided in § 220.612 and the storekeeper-gauger in charge at the distillery may approve such Forms 236.

(NNN) Section 220.615 is amended by striking from the last sentence the phrase "by the storekeeper-gauger".

(OOO) Section 220.622 is amended to read as follows:

§ 220.622 REPORT OF GAUGE AND TRANSFER.—The distiller shall gauge the rum, under the supervision of the storekeeper-gauger, by weight, either in the cistern room or in the denaturing bonded warehouse at the time of deposit therein, or by volume in accurately calibrated tanks in the cistern room. In any case, the distiller shall prepare Form 1520, in triplicate, reporting thereon the details of the gauge, and deliver all copies to the storekeeper-gauger. Upon completion of the gauge and transfer of the rum, the storekeeper-gauger will execute his report of removal on Form 573 and attach one copy of the Form 1520 to each copy of Form 573. The storekeeper-gauger will then forward one copy of each form to the Assistant Regional Commissioner, deliver one copy of each to the distiller, and retain one copy of each. (68A Stat. 634, 661; 26 U. S. C. 5194, 5331)

(PPP) Section 220.623 is amended as follows:

(1) By inserting in the first sentence, immediately after the phrase "in tank cars", the phrase "or tank trucks".

(2) By striking from the first sentence the phrase "with the Assistant Regional Commissioner".

(3) By inserting in the last sentence, immediately after the phrase "the tank cars", the phrase "or tank trucks".

(QQQ) Section 220.661 is revoked.

(RRR) Section 220.662 is amended by inserting in the first sentence, immediately following "Form 1598," the phrase "part 3,".

(SSS) Section 220.698 is amended by striking from the last sentence the word "storekeeper-gauger's".

(TTT) Section 220.712 is amended by changing the first sentence to read, "The outgoing distiller will complete his record Form 1598, and the storekeeper-gauger his record, Form 1686, as to the transfer to the successor of mash and beer in process, and the removal of all spirits produced by the outgoing distiller."

(UUU) Section 220.713 is amended as follows:

(1) By striking from the first sentence the phrase "materials, including those in process, received" and inserting in lieu thereof the phrase "materials in process received".

(2) By inserting in the last sentence, immediately after the words "If materials", the words "in process".

(VVV) Section 220.723 is amended by inserting in the first sentence, immediately after the words "all materials", the words "in process".

(WWW) Section 220.756 is amended by striking the first and second sentences and inserting in lieu thereof the following new sentences:

The distiller will deliver to the storekeeper-gauger, on or before the 5th day of the month succeeding that for which the report was rendered, one copy each of parts 1 and 2 and two copies of part 3 of Form 1598. The storekeeper-gauger will examine the report, execute the certificate of the internal revenue officer on both copies of part 3, return parts 1 and 2 and one copy of part 3 to the proprietor, and forward the original of part 3 to the Assistant Regional Commissioner.

(XXX) By inserting a new section, reading as follows, immediately after § 220.758:

§ 220.758a Operating Records.—Every proprietor of a registered distillery who has distillates from two or more types of mash in process at the same time shall maintain such operating records in support of Form 1598 as will permit the spirits to be traced through the various processes from the distillation of the beer to the deposit of the finished spirits in the receiving cisterns. Such operating records shall show, by kind, proof, and proof gallons, the deposits in unfinished spirits tanks, charges to the various stills for redistillation, redeposits in unfinished spirits tanks, and other movements of spirits. The operating records required by this section shall be kept available for inspection by internal revenue officers for not less than three years. (68A Stat. 637; 26 U. S. C. 5197)

(YYY) Section 220.766 is amended by inserting a comma immediately after the phrase "Form 1598" in the second sentence of paragraph (c) and by striking the comma following the phrase "Forms 52–A and 52–B" in the same sentence.

(ZZZ) Section 220.776 is amended by inserting at the beginning of the first sentence the phrase "Except as may be authorized in connection with the conduct of another business approved under the provisions of § 220.51,".

(AAAA) Section 220.777 is amended as follows:

(1) By striking the headnote thereto and inserting in lieu thereof the following new headnote, "Prohibited Removal of Spirits."

(2) By striking from the text of the section the phrase "in the absence" and inserting in lieu thereof the phrase "except under supervision".

Par. 2. 26 CFR (1954) part 221, Production of Brandy, is amended as follows:

(A) Section 221.60 is amended by inserting, immediately after the phrase, "or where liquors of any description are retailed, or", the phrase ", except as provided in § 221.61," and by striking the phrase ", except that the assistant regional commissioner may authorize the use of the distillery buildings or premises for miscellaneous storage of unfermentable materials during periods the distillery is under suspension".

(B) By inserting, immediately after § 221.60, the following new section:

§ 221.61 Use of Distillery Premises for Other Business.—Distillery premises may be used by the proprietor of the distillery for the conduct of other businesses not involving the production of alcoholic beverages but which (a) utilize materials, equipment, or processes similar to or interchangeable with those used for the production of brandy, or (b) involve the use of by-products or wastage from the production of brandy, or (c) utilize portions of premises or equipment, not required in the production of brandy, for entirely dissimilar businesses such as general storage or mechanical repair work: *Provided*, That the Director, Alcohol and Tobacco Tax Division, shall find, upon application made to him through the assistant regional commissioner in each case, that such use will not jeopardize the revenue and will not unduly increase administrative supervision. (68A Stat. 627; 26 U. S. C. 5171.)

(C) By amending Subpart E, Construction, to read as follows:

§ 221.70 DISTILLERY BUILDINGS.—Distillery buildings must be constructed of substantial materials and shall be so arranged and constructed as to afford adequate protection to the revenue and facilitate inspection by internal revenue officers: *Provided*, That the assistant regional commissioner may, in his discretion, approve fruit distilleries having equipment and apparatus, except as required by § 221.72, not located in a room or building, if, in his opinion, the location and construction are such that the revenue is not endangered and no additional supervision would be required: *Provided further*, That brandy may not be filled into barrels or drums except within a room or building. Where a brandy receiving room is provided, it must be constructed and equipped in accordance with the provisions of § 221.71. Except as otherwise provided in this part, distillery buildings must be completely separated from contiguous buildings not on the distillery premises by unbroken partitions of substantial construction extending from the ground to the roof in a direct vertical line. The assistant regional commissioner may authorize communicating doors from distillery premises to an off-premises room or building when, in his opinion, such door would not constitute a jeopardy to the revenue, but no such door shall be permitted in a brandy receiving room. All outside doors of distillery buildings shall be equipped for locking with Government locks. Notwithstanding any other provision of this part, openings may be provided in roofs or outside walls of distillery buildings for safety equipment or for ventilating, lighting, or heating purposes. Such openings shall be equipped with substantial metal gratings, screens, or other protective devices when the assistant regional commissioner determines that such devices are necessary for the protection of the revenue. Outside tanks used as receptacles for spirits and stills must be enclosed and protected in the manner required by § 221.129a. Where equipment or apparatus is not located in a room or building, electric flood lights shall be installed for lighting the premises at night. Any other protective measures deemed essential by the assistant regional commissioner may be required for distillery buildings or for equipment located within or without the distillery buildings.

§ 221.71 RECEIVING ROOM.—The proprietor may provide a receiving room in which to locate the receiving tanks. If such a room is provided, it shall be constructed of substantial materials. Where the floors, ceiling or walls are constructed of wood, the boards must be matched tongue and groove, except that wood floors may be of other than tongue and groove lumber if laid double with the second layer crossing the first at an angle of more than 20 degrees. Receiving room windows shall be substantially constructed and so arranged and equipped that they may be securely fastened on the inside. Receiving room windows which, because of their location with respect to the ground, a fire escape, roof, setback or balcony, create an additional jeopardy to the revenue, must be of the detention type or be protected by iron bars or solid shutters. Where solid shutters are provided they must be equipped for fastening on the inside with a Government lock or cap seal. No door, window, or other opening leading from the receiving room into any other building or room, except the distilling building or room, will be permitted: *Provided*, That where the receiving room and brandy deposit room adjoin each other there may be a communicating door between them. All doors of the receiving room shall be locked on the inside with Government locks, except the entrance door and the communicating door, if any, between the receiving room and the brandy deposit room. The entrance door shall be locked on the outside of the receiving room with a Government seal lock and the communicating door between the receiving room and the brandy deposit room shall be locked on the brandy deposit room side. The receiving room must be well lighted, and of sufficient size and so equipped as to permit prompt and convenient conduct of operations required therein. A sign must be placed over the entrance door bearing the words "Receiving Room."

§ 221.72 BRANDY DEPOSIT ROOM.—Unless all brandy is removed from the distillery in accordance with §§ 221.515–221.520, during the regular working hours of the same day on which it is drawn from the receiving tanks, there must be provided a room (or building) to be known as the brandy deposit room (or building) for the temporary storage of brandy pending removal thereof from the distillery premises. The brandy deposit room shall be constructed of substantial materials. Where the floors, ceiling or walls are constructed of wood, the boards must be matched tongue and groove, except that wood floors may be of other than tongue and groove lumber if laid double with the second layer

crossing the first at an angle of more than 20 degrees. No door, window, or other opening leading from the brandy deposit room into any other building or room, except the distilling building or room, will be permitted: *Provided,* That where the brandy deposit room and the receiving room adjoin each other there may, as provided in § 221.71, be a communicating door between them. All doors of the brandy deposit room shall be locked on the inside with Government locks, except the entrance door, which shall be locked on the outside of the room with a Government seal lock. The brandy deposit room must be well lighted and of sufficient size and so equipped as to permit of prompt and convenient conduct of operations required therein. A sign must be placed over the entrance of the room bearing the words "Brandy Deposit Room."

§ 221.73 FILLED PACKAGE STOREROOM.—Where packages are filled from tanks in the brandy deposit room and it is desired to store such filled packages temporarily pending removal from the distillery, a separate compartment or room must be provided within the brandy deposit room for the storage thereof. The construction of such filled package storeroom must conform to the applicable provisions of § 221.72. All doors of this compartment or room shall be equipped for locking on the inside with Government locks, except the entrance door which shall be equipped for locking on the outside. The entrance door of the filled package storeroom shall open into the other part of the brandy deposit room.

§ 221.74 EMPTY CONTAINER STOREROOM.—If empty packages are to be stored on the distillery premises, a separate room or building must be provided for such purpose. Such room or building shall not have any means of interior communications with any other room or building used in connection with the production or storage of brandy: *Provided,* That the assistant regional commissioner may authorize a door connecting with the brandy receiving or deposit room when, in his opinion, such opening will not constitute a jeopardy to the revenue. Such door must be equipped on the brandy receiving room or deposit room side with a Government lock. The empty container building may be used for general cooperage purposes.

§ 221.75 GOVERNMENT OFFICE.—The proprietor shall provide and maintain on the distillery premises for the exclusive use of internal revenue officers a securely constructed, well-lighted, heated, and ventilated office of suitable dimensions: *Provided,* That where the proprietor operates an internal revenue bonded warehouse on or contiguous to the distillery premises, or a bonded wine cellar contiguous to such premises, and a Government office conforming to the requirements specified in this section is provided on the warehouse or wine cellar premises, and such office is so located as to be suitable for the use of internal revenue officers assigned to the distillery, a separate Government office need not be provided on the distillery premises. The Government office shall be equipped with toilet and lavatory facilities and with a suitable number of desks, chairs, file cases, and such other furniture as may be necessary for the keeping of Government records and the preparation of reports. Where distilling materials, etc., are tested by internal revenue officers, the Government office shall also be provided with running water, and such tables and shelves as may be required, unless suitable laboratory facilities are available to internal revenue officers elsewhere on the premises. The door of the Government office shall be equipped with a cylinder type lock, and a sufficient number of keys therefor shall be furnished the assistant regional commissioner for the use of internal revenue officers. Where deemed necessary to afford adequate security to Government property, the assistant regional commissioner may require the windows of the Government office to be protected by shutters or iron bars, and the door to be so equipped that it may be securely fastened with a Government lock. A sign must be placed over the entrance door bearing the words, "Government Office". Where brandy is drawn into packages from receiving or brandy storage tanks the distiller must provide beside the scales on which the packages are weighed a desk or table and chair for the use of the storekeeper-gauger in preparing his reports of gauge.

§ 221.76 GOVERNMENT CABINET.—There shall be provided in the Government office a cabinet of adequate security and size, suitably equipped for locking with a Government seal lock, for use in safeguarding Government locks, keys, seals, and other Government property, and stamps in the custody of internal revenue officers. Each such cabinet shall be subject to approval by the assistant regional commissioner.

(D) Section 221.111 is amended by striking from the first sentence the words, "brandy to a weighing tank in a warehouse on the same

or contiguous premises or to a weighing tank in a contiguous bonded wine cellar, or to a weighing tank in a contiguous distillery, and gauged therein." and inserting in lieu thereof the words, "brandy to tanks on the same or contiguous premises as provided by § 221.542."

(E) Section 221.115 is amended by striking from the proviso in the first sentence the words "charges, as authorized by § 221.92," and inserting in lieu thereof the words, "chargers by fixed pipelines,".

(F) Section 221.116 is amended by striking the second sentence.

(G) Section 221.118 is amended by inserting at the end thereof the following new sentence:

The waste discharge line of every still, except those used for primary distillation, must be secured to the sewer in such manner as to preclude the recovery of brandy from the waste discharge line: *Provided*, That where it is not practicable to secure such discharge lines to sewers, the assistant regional commissioner may approve other construction if he finds that such other construction will afford adequate protection.

(H) Section 221.120 is amended by changing the first and second sentences to read as follows:

All tanks used as receptacles for brandy shall be equipped with a suitable measuring device whereby the actual contents will be correctly indicated. Openings in the tanks for cords or wires for floats and counterweights, where used, must be no larger than are absolutely necessary to accommodate the cords or wires.

(I) Section 221.122 is amended by changing the headnote thereto to read "TANKS FOR RETENTION OF UNFINISHED BRANDY DURING ALTERNATE OPERATIONS".

(J) Section 221.125 is amended to read as follows:

§ 221.125 HIGH WINES, LOW WINES, SINGLINGS, OR UNFINISHED BRANDY TANKS.—(a) *General requirements.*—Where unfinished brandy is produced the distiller shall provide suitable tanks for the reception thereof. The tanks shall be constructed and arranged in accordance with § 221.119, and equipped with a suitable measuring device conforming to the requirements of § 221.120, whereby the actual contents will be correctly indicated. Each such tank shall have plainly and legibly painted thereon the words "High wines tank", "Low wines tank", "Singlings tank" or "Unfinished brandy tank", as the case may be, followed by its serial number and capacity in gallons. These tanks shall be connected by means of fixed pipelines with the stills in which the unfinished brandy is to be redistilled, or, if it is desired to mingle unfinished brandy with distilling material about to be distilled, the tanks may be connected by means of fixed pipelines with the distilling materials sump or the chargers of the still, or the distilling material pipeline leading to the still, in accordance with § 221.126. The pipelines connected with the tanks shall be provided with valves to control the flow of unfinished brandy into and out of the tanks, and such valves shall be so constructed that they may be closed and secured with Government locks. Where the tanks are connected with a closed, locked still in which the unfinished brandy is redistilled, the valves controlling the flow of the unfinished brandy into and out of the tanks need not be equipped for locking with a Government lock. By the term "closed, locked still" is meant a still having all openings by which access may be had to the brandy or singlings closed and secured with Government locks or sealed.

(b) *Special equipment.*—Where it is desired to reduce or scrub unfinished brandy before redistillation, there shall be permanently connected to the tank in which the unfinished brandy is reduced or scrubbed the necessary air and water lines. Such air and water lines shall be equipped with check valves located near the point of entry to the tank and the water lines shall be equipped with valves so arranged that they may be locked with Government locks: *Provided*, That if brandy is to be reduced during other than regularly assigned hours of supervision, the water lines shall not be equipped for locking but shall be equipped with metering or measuring devices by which the quantity of water added to a tank may be determined. If the distiller so desires, he may provide

mechanical agitators in lieu of air lines. The introduction of any materials or substances into the tanks during other than regularly assigned hours of supervision must be accomplished by mechanical devices which effectively prevent the abstracting of brandy. Where the distiller desires to charge pot or kettle stills in the absence of the storekeeper-gauger, he must provide such measuring devices as may be necessary to determine the quantity of unfinished brandy withdrawn from the tanks. If the distiller desires to withdraw samples from the tanks, it will be necessary that he install sampling devices unless authority to withdraw the samples under supervision has been given pursuant to § 221.504.

(K) Section 221.127 is amended as follows:

(1) By inserting in two places in the fourth sentence, which begins, "At distilleries where", immediately after the words "twice a month to gauge", the words "or supervise the gauging of".

(2) By changing the sixth sentence, which begins "Each receiving tank", to read, "Each receiving tank shall be equipped with a suitable measuring device, such as an etched gauge glass, or other equally accurate gauge device whereby the actual contents will be correctly indicated."

(3) By inserting, immediately after the sixth sentence, the following new sentence, "Where gauge glasses are used provision must be made to exhaust or flush the glasses so they will accurately reflect the contents of the tanks."

(4) By inserting, immediately after the twelfth sentence, which begins, "Pipelines connected", the following new sentence, "The inlet to each receiving tank shall be equipped with a valve located in close proximity to the receiving tank and so arranged that it may be locked with a Government lock."

(5) By inserting at the end of the section the following new sentence, "No receiving tank shall be used until it has been calibrated, or in the case of existing tanks, recalibrated, and approved by an internal revenue officer, and a certificate, Form 244, has been attached thereto as provided in § 221.313 a."

(L) Section 221.128 is amended by placing a period after the phrase "any of the tanks" in the first sentence and striking the remainder of the section.

(M) By inserting a new section, reading as follows, immediately after § 221.129:

§ 221.129a OUTSIDE TANKS AND STILLS.—Tanks used as receptacles for brandy and stills which, pursuant to § 221.70, are not located within a building, shall conform to the requirements of this section in addition to other applicable provisions of this part. The equipment shall be of substantial metal construction and shall be erected on a solid concrete base or foundation. The tanks and stills shall be completely enclosed by a fence extending to a height of at least ten feet above the ground, constructed of not less than No. 6 gauge, nor more than 2-inch mesh, expanded metal or woven wire, with at least three rows of barbed wire superimposed on the top thereof. The fence posts shall be made of iron or steel, embedded securely in a continuous concrete foundation which shall be at least twelve inches thick and extend not less than eighteen inches below the ground. A suitable gate in such fence shall be provided, which gate shall be of equal security and shall be equipped with a hasp and staple for the reception of a lock. Pipelines to and from the equipment shall conform to the requirements of § 221.130. The assistant regional commissioner may require, in any case in which he deems necessary, in addition to the installation of electric flood lights for lighting the enclosure as required by § 221.70, the maintenance of watchman services, or other protective measures or devices. (68A Stat. 628; 26 U. S. C. 5173.)

(N) Section 221.254 is amended by inserting, immediately after the word "materials", in the headnote and in two places in the text the words "in process".

(O) Section 221.263 is amended by inserting, immediately after the word "materials" in the headnote and in the text, the words "in process".

(P) Section 221.292 is amended by inserting in paragraph (b), and the headnote thereto, the words "in process" immediately after the word "materials".

(Q) Section 221.293 is amended by inserting in paragraph (b), and the headnote thereto, the words "in process" immediately after the word "materials".

(R) Section 221.300 is amended by inserting in paragraph (c), and the headnote thereto, the words "in process" immediately after the word "materials".

(S) Section 221.302 is amended by inserting in paragraph (b), and the headnote thereto, the words "in process" immediately after the word "materials".

(T) Section 221.303 is amended by inserting in paragraph (b), and the headnote thereto, the words "in process" immediately after the word "materials".

(U) By inserting a new section, reading as follows, immediately after § 221.313:

§ 221.313a Approval of Receiving Tanks.—When the officer who is required to examine the receiving tanks is satisfied that the same are properly constructed, and that the gauge glasses or other gauge devices are accurate, he will so report to the assistant regional commissioner, in writing, and will securely attach to the receiving tank a certificate on Form 244.

(V) Section 221.353 is amended as follows:

(1) By striking from the first sentence the phrase "Except as provided in § 21.371 the" and inserting in lieu thereof the word "The".

(2) By striking from the fourth sentence, which begins "Ordinarily, storekeeper-gaugers", the words "gauging and".

(3) By striking from the fifth sentence, which begins "At distilleries", the phrase "gauge the brandy and supervise" and inserting in lieu thereof the phrase "gauge or supervise the gauging of the brandy and to supervise".

(W) By inserting a new section, reading as follows immediately after § 221.354:

§ 221.354a Distiller's Schedule of Operations.—The distiller shall furnish the storekeeper-gauger a schedule of planned operation at his plant as early as such schedule can be prepared. At least one day's written notice must be given the storekeeper-gauger of any operation requiring supervision. This schedule shall show all activities which require the immediate supervision or attention of a storekeeper-gauger, such as, the kind and quantity of brandy to be received for redistillation, receiving room (or tank) operations, including the approximate number of packages to be gauged either for taxpayment or for deposit (with notations as to any packages which it is intended to subsequently withdraw on the original gauge), as well as the anticipated removals by pipeline or by tank car or tank truck, and scheduled repairs which will involve the breaking or replacing of seals or the manipulation of Government locks.

(X) Section 221.355 is amended as follows:

(1) By changing the headnote to read, "*Receipt of materials.*"

(2) By striking the first sentence and inserting in lieu thereof the following new sentences:

The distiller will maintain a record of all distilling materials received on the distillery premises, showing the date of receipt, the name of the person from whom received, and the kind and quantity of each material received. Where commercial invoices or bills of lading contain the required information, a separate record will not be required. Such record, commercial invoices or bills of lading shall be kept available for inspection by internal revenue officers at all times during regular business hours.

(3) By striking from the fourth sentence, which begins "The distilling material", the phrase ", as provided in § 221.92,".

(Y) Section 221.357 is amended to read as follows:

§ 221.357. RECORD OF MATERIALS RECEIVED.—Where wine or distilling material is received in bond from a bonded wine cellar for distillation, the distiller will record the receipt thereof on Form 15 and will complete Form 703, prepared by the consignor, in accordance with the instructions on the form. Where wine, or brandy for redistillation, is received the alcoholic content thereof will also be entered on Form 15. (67A Stat. 637; 26 U. S. C. 5197.)

(Z) Section 221.362 is amended as follows:

(1) By inserting in the eighth sentence, which begins "The distiller", immediately after the phrase "each lot of distilling material", the phrase "received in bond".

(2) By striking from the ninth sentence, which begins "The kind,", the phrase "material distilled" and inserting in lieu thereof the phrase "distilling material received in bond".

(3) By striking the last sentence and inserting in lieu thereof the following new sentences:

Where two or more types of distilling material are produced, or received, or processed in the same month, a separate page of part 1 of Form 15 shall be used to report each type of material. Each page shall bear a notation identifying the type of distilling material reported thereon.

(AA) Section 221.371 is revoked.

(BB) Section 221.372 is revoked.

(CC) Section 221.373 is revoked.

(DD) Section 221.382 is amended by inserting in the second sentence, immediately after the phrase "until gauged by", the phrase ", or under the supervision of,".

(EE) Section 221.383 is revoked.

(FF) Section 221.384 is amended by striking the second and third sentences.

(GG) Section 221.427 is amended by striking the last sentence.

(HH) Section 221.437 is amended as follows:

(1) By changing the first sentence to read, "The distiller will enter on his monthly return, Form 15, part 1, all removals of fusel oil."

(2) By changing the period at the end of the second sentence to a comma and adding the following, "including on the form the name and address of the consignee."

(II) Section 221.450 is amended by striking from the first sentence the phrase "§ 221.454" and inserting in lieu thereof the phrase "part 225 of this title".

(JJ) Section 221.454 is revoked.

(KK) Section 221.460 is amended by changing the first sentence to read, "Brandy may be received at the distillery for redistillation after the distiller has given notice, in duplicate, to the assistant regional commissioner."

(LL) Section 221.461 is revoked.

(MM) Section 221.462 is amended to read as follows:

§ 221.462 ACTION BY ASSISTANT REGIONAL COMMISSIONER.—Upon receipt of a notice of intent to receive brandy for redistillation, the assistant regional commissioner will note the penal sum of the distiller's bond on both copies of the notice, retain one copy and furnish one copy to the storekeeper-gauger at the distiller's premises. The assistant regional commissioner will advise the storekeeper-gauger of any subsequent change in the penal sum of the distiller's bond. (68A Stat. 634; 26 U. S. C. 5194)

(NN) Section 221.463 is amended as follows:

(1) By striking the first and second sentences and inserting in lieu thereof the following new sentence, "When the distiller desires to receive brandy for redistillation, he shall prepare Form 236, properly modified for that purpose, covering the transfer of such spirits."

(2) By striking the third sentence, which begins "Where the consignor", and inserting in lieu thereof the following new sentences:

Where the consignor distillery or warehouse is located in the same region, an original and five copies of the Form 236 will be prepared and delivered to the storekeeper-gauger. An original and six copies of the form will be prepared if the consignor distillery or warehouse is located in a different region.

(3) By striking the fourth sentence, which begins "The storekeeper-gauger", and inserting in lieu thereof the following new sentence:

If the storekeeper-gauger finds that the penal sum of the distiller's bond is sufficient to cover the redistillation of the brandy described in the Form 236, he will execute his certificate on all copies of the form and return all copies to the distiller.

(4) By striking from the last sentence the phrase "and one copy of the approved special application".

(OO) Section 221.466 is amended as follows:

(1) By inserting, immediately after the first sentence, the following new sentence:

Brandy for redistillation shall be mingled with wine or fermented material, or transferred to the charger or sump, of introduced into tank in the distilling system only under the supervision of a storekeeper-gauger.

(2) By striking the fourth sentence, which begins "Where such brandy".

(PP) Section 221.468 is amended by striking the second sentence, which begins "Where such brandy".

(QQ) Section 221.469 is amended to read as follows:

§ 221.469 GAUGE OF BRANDY.—Upon receipt of application, Form 236, the distiller, when he desires to make shipment, will give a copy of Form 236 to the storekeeper-gauger and furnish a complete description of the brandy to be shipped. Where the brandy is removed by pipeline to a contiguous distillery, it may be gauged in weighing tanks either before removal or upon receipt: *Provided*, That where the brandy is removed to a contiguous distillery operated by the same distiller, or an affiliate or subsidiary of the distiller, it may be gauged by volume in accurately calibrated tanks on the premises of the transferring distiller. The storekeeper-gauger will verify the distiller's gauge, as provided in § 221.541. The distiller will prepare his report of gauge on Form 1520. An original and four copies will be prepared for intraregion shipments and an original and five copies for interregion shipments. The marking of containers will be made in accordance with §§ 221.549–221.556 insofar as applicable, and in addition to required transfer-in-bond markings for containers of brandy removed for redistillation there will be stenciled thereon the words, "For Redistillation": *Provided*, That where containers of spirits are removed to a contiguous distillery for prompt redistillation, the transfer-in-bond markings and the words "For Redistillation" need not be placed on the containers. The distiller will note on all gauge reports covering removal of brandy for redistillation the words, "For Redistillation". Forms 236 and 1520 will be disposed of in accordance with § 221.611 for intraregion transfers and § 221.619 for interregion transfers. (68A Stat. 634; 26 U. S. C. 5194.)

(RR) Section 221.470 is amended by changing the comma following the phrase "'For Redistillation'" in the second sentence to a period and striking the remainder of the sentence.

(SS) Section 221.495 is amended as follows:

(1) By striking from the end of the first sentence the phrase "shown in paragraphs (a), (b), and (c) of this section:" and inserting in lieu thereof "follows:".

(2) By striking the phrase "three pints" where it appears in paragraphs (a) and (b) and inserting in lieu thereof the phrase "two quarts".

(TT) Section 221.504 is amended as follows:

(1) By inserting immediately after the headnote a new sentence reading, "All samples of finished brandy must be taken under the supervision of the storekeeper-gauger."

(2) By striking from the first sentence the phrase "Samples of brandy may", and inserting in lieu thereof the phrase "Samples of unfinished brandy, including those from tanks, shall".

(3) By changing the period at the end of the first sentence to a colon and adding the following:

Provided, That where new equipment is being tested, the storekeeper-gauger may supervise the taking of samples of unfinished brandy: *Provided further*, That the assistant regional commissioner may, upon receipt of written application by the distiller, authorize the storekeeper-gauger to regularly supervise the taking of samples of unfinished brandy from tanks. No application to regularly take samples of unfinished brandy from tanks under supervision, rather than by sampling devices, shall be approved unless it is shown by the distiller that such procedure would not be burdensome and that requests for supervision of such sampling would be made only at such time as the storekeeper-gauger is free from other supervisory duties.

(4) By striking the second sentence, which begins "All samples,".

(5) By inserting in the third sentence, immediately after the phrase "taking of the samples", the phrase "(other than those taken by means of approved mechanical sampling devices)".

(UU) Section 221.507 is amended by changing the first sentence to read, "The storekeeper-gauger shall keep on Form 1615, in quadruplicate, a record of all taxable samples removed."

(VV) Section 221.518 is amended by inserting, immediately following the phrase "in tank cars", the phrase "or tank trucks".

(WW) Section 221.522 is amended by striking from the first sentence the phrase "gauge the same" and inserting in lieu thereof the phrase "gauge or supervise the gauging of same".

(XX) Section 221.523 is amended by striking from the last sentence the figures "221.91" and inserting in lieu thereof the figures "221.73".

(YY) Section 221.529 is amended as follows:

(1) By inserting in the first sentence, immediately after the phrase "assign an officer to gauge", the phrase "or supervise the gauging of".

(2) By striking from the last sentence the phrase "gauge the brandy", and inserting in lieu thereof "perform such duty".

(ZZ) Section 221.530 is amended by inserting in the second sentence, immediately after the phrase "storekeeper-gauger to gauge", the phrase "or supervise the gauging of".

(AAA) Section 221.536 is amended by striking from the last sentence the phrase "to be marked on the empty" and inserting in lieu thereof the phrase "of the".

(BBB) Section 221.538 is amended by inserting in the first sentence, immediately following the phrase "the date of filling, and", the phrase ", except as provided in § 221.551a,".

(CCC) Section 221.541 is amended as follows:

(1) By inserting, immediately after the headnote the following new sentence:

All brandy drawn from receiving tanks (a) for taxpayment and removal by pipeline or in tank cars or tank trucks, or (b) into packages which are to be taxpaid immediately on being filled or after a period of temporary storage in the brandy deposit room, or (c) into packages, tank cars, or tank trucks, which are to be withdrawn on the original gauge from any internal revenue bonded warehouse, or (d) into tank cars or tank trucks for exportation, shall be carefully gauged by the storekeeper-gauger who will also record the details of the gauge and other required information on the report of gauge, Form 1520.

(2) By striking the first sentence and inserting in lieu thereof the following new sentences:

Brandy drawn from receiving tanks for all other purposes will be carefully gauged by the distiller, under the supervision of the storekeeper-gauger by weighing, except as provided by § 221.542, and proofing the brandy in accordance with this subpart and the Gauging Manual (part 186 of this title) and the details thereof will be entered by the distiller on the report of gauge, Form 1520. The total number of barrels shown on Form 1520 to have been filled shall be verified.

(3) By inserting immediately after the first sentence the following new sentence:

The storekeeper-gauger shall in every instance verify the proof (before and after reduction) of the brandy in the receiving tank and determine, either by weight or by volume, the contents of each receiving tank before and after any brandy is withdrawn therefrom. Where brandy is gauged by the distiller for removal in tank cars, tank trucks, or by pipeline, the storekeeper-

gauger shall personally verify the net weight or wine gallons, proof, and tax gallons and enter his name and title on all copies of the Form 1520.

(4) By inserting in the second sentence immediately after the word "Entries", the words "on Form 1520".

(5) By changing the third sentence to read, "The proof of distillation of the brandy gauged shall be noted on the Form 1520 in every instance."

(6) By striking from the fourth sentence, which begins "The proof of" the word "being" and inserting in lieu thereof the phrase "the brandy is".

(7) By striking from the seventh sentence, which begins "Where the proof", the phrase "this title (Gauging Manual)" and inserting in lieu thereof the phrase "the Gauging Manual".

(8) By striking from the ninth sentence, which begins "In any such case", the phrase "shall make notation on Form 1520 that the spirits were reduced to a whole degree of proof or, if they were not so adjusted, the fractional degree of proof at which withdrawn." and inserting in lieu thereof the phrase "shall show on Form 1520 the whole or fractional degree of proof at which the brandy is withdrawn."

(9) By striking from the last sentence the phrase "for shipment".

(DDD) By inserting two new sections reading as follows, immediately after § 221.541:

§ 221.541a STOREKEEPER-GAUGER TO CHECK DISTILLER'S GAUGE.—In every instance where the removal gauge of brandy is performed and reported by the distiller, the storekeeper-gauger shall compare his determination of the total quantity withdrawn from the receiving tank with the total quantity reported as withdrawn by the distiller and where the brandy is drawn into packages the storekeeper-gauger shall also, from time to time, verify the tares, proofs, gross weights, and tax gallonages as determined by the distiller. Where the storekeper-gauger finds, as the result of his sampling of a gauge made by the distiller, or upon comparing his gage of a receiving tank with the total reported withdrawn by the distiller, significant discrepancies in the distiller's entry record, or the marks and brands required to be placed on any container, the distiller shall make such corrections of the gauge, the entry record, and the marks and brands as may be required by the storekeeper-gauger to insure that the gauge, the entry record, and the marks and brands are correct. (68A Stat. 633, 639; 26 U. S. C. 5192, 5193, 5212.)

§ 221.541b ENTRY FOR SUBSEQUENT WITHDRAWAL ON ORIGINAL GAUGE.—Where the distiller desires to draw brandy from receiving tanks for entry into an internal revenue bonded warehouse and subsequent withdrawal on the original gauge, he shall notify the storekeeper-gauger of such intention in writing in order that the gauge and report of such brandy may be made by the storekeeper-gauger. The notice, which shall be prepared on the distiller's letterhead, and be signed by the distiller or a designated attorney-in-fact, shall contain the following information:

(a) A statement that the brandy identified therein is to be entered for deposit and subsequent withdrawal on the original gauge;

(b) The registry number and location of the warehouse in which the brandy is to be entered;

(c) The kind of brandy;

(d) The proof of distillation;

(e) The kind of cooperage, or, if not to be packaged, the means of removal; and

(f) The approximate quantity to be removed.

The storekeeper-gauger will note on all copies of Form 1520 covering the gauge of such brandy, "Withdraw on original gauge." The notice will be

securely attached to the copy of the Form 1520 retained by the storekeeper-gauger at the distillery. (68A Stat. 633, 634, 639, 647; 26 U. S. C. 5193, 5194, 5212, 5245)

(EEE) Section 221.542 is amended as follows:

(1) By striking from the first sentence the phrase "to a bonded warehouse" and inserting in lieu thereof the phrase "to an internal revenue bonded warehouse".

(2) By inserting in the proviso in the first sentence, immediately after the phrase "for use in wine production", the phrase ", and brandy transferred by pipeline to an internal revenue bonded warehouse or distillery operated by the distiller, or an affiliate or subsidiary of the distiller, on contiguous premises,".

(3) By striking from the second sentence the word "storekeeper-gauger" and inserting in lieu thereof "distiller".

(FFF) Section 221.544 is amended to read as follows:

§ 221.544 For Storage in Brandy Deposit Room.—When brandy to be temporarily stored in the brandy deposit room is gauged, the storekeeper-gauger or distiller (as provided in § 221.541) will prepare a report thereof on Form 1520, in triplicate. The storekeeper-gauger will forward one copy of the form to the assistant regional commissioner on the same day the brandy is gauged, deliver or return one copy to the distiller, and retain the remaining copy as a permanent record in his office.

(GGG) Section 221. 547 is amended by striking the phrase "the storekeeper-gauger will prepare and dispose of" and inserting, immediately after the phrase "the reports of gauge, Form 1520," the phrase "will be prepared and disposed of".

(HHH) Section 221.549 is amended to read as follows:

§ 221.549 General.—Any cask or package which contains or has on its interior or exterior any substance that will prevent the correct ascertainment of tare shall not be used. The tare or weight of empty packages will be determined immediately prior to filling by the person responsible for the gauge: *Provided*, That the tare of a number of packages may be ascertained and marked thereon before any are filled but not exceeding the number which are to be filled the same day or the following day. If the packages are not to be filled until the following day, they must be locked in the receiving or brandy deposit room after being weighed. Whenever there is a change in the specifications as to capacity and weight of cooperage, the distiller shall give notice to the storekeeper-gauger. All packages of brandy, when filled, shall be further marked and branded as provided by this subpart, and where such packages are tax paid, the prescribed stamps will be affixed thereto and cancelled in the manner prescribed in §221.567. (68A Stat. 633, 634, 639; 26 U. S. C. 5193, 5194, 5212)

(III) Section 221.550 is amended as follows:

(1) By striking the first sentence of paragraph (a) and inserting in lieu thereof the following new sentences:

There shall be marked on the head of each package the name of the distiller or the person in whose name the brandy was produced, the registry number of the distillery, the city or town and State in which the distillery is located, the kind of cooperage, the serial number of the package, the kind of brandy, the date of filling, the proof at which distilled, and, except as provided in § 221.551a, the original proof gallons, the original proof and tare determined at the time of filling. If packages are taxpaid in the distillery, the date of taxpayment and serial number of the wholesale liquor dealer stamp shall also be marked upon the head of each package.

(2) By striking from the third sentence of paragraph (d), which begins "The proof", the phrase "proof gallons, tare and

withdrawal data" and inserting in lieu thereof the phrase "proof gallons, and tare (where used), and withdrawal data".

(JJJ) By inserting the following new section immediately after § 221.551:

§ 221.551a OPTIONAL MARKING.—The markings on packages and barrels with respect to proof, proof gallons and tare which are required and illustrated in §§ 221.538, 221.550 and 221.551 may, at the option of the distiller, be omitted from the package or barrel if such package or barrel is filled to capacity and if there is shown in lieu of such markings the rated capacity, in gallons, of the package or barrel as prescribed by the manufacturing specifications. Where used, the rated capacity shall be in letters and figures not less than one-half inch in height and may be shown as "RC——G." (68A Stat. 633; 26 U. S. C. 5193.)

(KKK) By inserting a new section reading as follows, immediately preceding § 221.556:

§ 221.555a PRODUCT IDENTIFICATION.—The distiller shall be responsible for correctly identifying brandy at the time of its gauge for removal from receiving tanks and for the accuracy of prescribed marks and brands. (64 Stat. 633, 634; 26 U. S. C. 5193, 5194)

(LLL) Section 221.557 is amended by striking from the last sentence the phrase "except the instruments for proofing the brandy".

(MMM) Section 221.558 is amended as follows:

(1) By changing the first sentence to read, "The storekeeper-gauger shall balance the scales before the weighing of packages, either empty or filled, is commenced, and will frequently test the accuracy of such scales by means of test weights provided in accordance with § 221.113."

(2) By striking the second sentence.

(NNN) Section 221.559 is amended as follows:

(1) By inserting, immediately after the headnote, a new sentence, reading, "The proof of brandy shall be determined in accordance with the instructions set forth in the Gauging Manual (part 186 of this title)."

(2) By changing the first sentence to read, "The storekeeper-gauger shall determine, or verify, as the case may be, the proof of all brandy gauged."

(3) By striking the second sentence, which begins, "The storekeeper-gauger will".

(OOO) Section 221.560 is revoked.

(PPP) Section 221.589 is amended as follows:

(1) By changing the first sentence to read:

Where the distiller operates an internal revenue bonded warehouse on the distillery premises and brandy produced at the distillery is to be entered for deposit in such warehouse, the brandy, shall, as authorized by § 221.515, be drawn into approved containers, gauged, marked, and branded, and then immediately deposited in such warehouse, or, in the case of pipeline transfers, gauged and deposited in the warehouse tanks in the manner provided in § 221.542.

(2) By striking from the second sentence the word "immediate".

(3) By inserting in the fourth sentence, immediately after the phrase "The storekeeper-gauger", the phrase "or distiller, as required by § 221.541,".

(4) By changing the last sentence to read, "On completion of the form, the distiller will execute his entry of the brandy for deposit."

(QQQ) Section 221.593 is amended as follows:

(1) By striking the third sentence, which begins "The storekeeper-gauger".

(2) By striking from the last sentence the word "direct".

(RRR) By inserting a new section, reading as follows, immediately after § 221.596:

§ 221.596a FORMS 236 ORIGINATING AT CONSIGNOR PREMISES.—Where brandy is to be transferred to and entered for deposit in an internal revenue bonded warehouse operated by the distiller, or an affiliate or subsidiary of the distiller, in the same region and the receiving warehouse has on file a bond in the maximum penal sum of $200,000, the consignee warehouseman may designate an agent or employee of the consignor distiller as an attorney-in-fact to execute Form 236 for the consignee warehouseman. The consignee warehouseman shall file letter application with the assistant regional commissioner for permission to establish such procedure, together with power of attorney on Form 1534, in triplicate, executed as provided in § 221.173, authorizing an individual at the consignor premises to execute Form 236 for the consignee warehouseman. If the assistant regional commissioner approves the application, he shall so notify the applicant and furnish the storekeeper-gaugers at the consignor premises a copy of the approved Form 1534 on which he has noted the fact that the consignee warehouse has on file a bond in the maximum penal sum. The assistant regional commissioner will advise the storekeeper-gauger of any subsequent change in the penal sum of the consignee's bond. The designated attorney-in-fact may thereafter execute Forms 236 covering transfers to the designated warehouse in the manner provided in § 221.595 and the storekeeper-gauger at the distillery may approve such Forms 236.

(SSS) Section 221.598 is amended as follows:

(1) By striking from the third sentence, which begins, "The details of", the word "storekeeper-gauger" and inserting in lieu thereof the word "distiller".

(2) By inserting in the last sentence, immediately after the phrase, "the storekeeper-gauger", the phrase "or distiller, as required by § 221.173,".

(TTT) Section 221.606 is amended by striking the phrase "Upon receiving an order to gauge brandy to be" and inserting in lieu thereof the phrase "When brandy is to be".

(UUU) Section 221.607 is amended as follows:

(1) By striking from the first sentence the phrase "in the immediate presence" and inserting in lieu thereof the phrase "under the supervision".

(2) By striking the second and third sentences.

(3) By changing the fourth sentence, which begins "The officer", to read, "The level of the brandy above or below the full mark for each compartment, and the temperature of the brandy at filling will be entered on Form 1520; for example: 'Filled 2 inches above full mark at 80 degrees F'."

(4) By inserting, immediately after the fourth sentence, a new sentence, reading, "The storekeeper-gauger will seal the tank car or tank truck as soon as it is filled and will note on Form 236 the serial numbers of the seals used."

(5) By striking the last sentence.

(VVV) By inserting a new section, reading as follows, immediately after § 221.613:

§ 221.613a FORMS 236 ORIGINATING AT CONSIGNOR PREMISES.—Where brandy is to be transferred to and entered for deposit in an internal revenue bonded warehouse operated by the distiller, or an affiliate or subsidiary of the distiller, located in a different region and the receiving warehouse has on file a bond in the maximum penal sum of $200,000, the consignee warehouseman may designate an agent or employee of the consignor distiller as an attorney-in-fact to execute Form 236 for the consignee warehouseman. The consignee warehouseman shall file letter application with the assistant regional commissioner for permission to establish such procedure, together with power of attorney on Form 1534, in quadruplicate, executed as provided in § 221.173, authorizing an individual at the consignor premises to execute Form 236 for the consignee warehouseman. If the assistant regional commissioner approves the application, he shall so notify the applicant and furnish the assistant regional commissioner of the region in which the consignor distillery is located two copies of the approved Form 1534 on which he has noted the fact that the consignee warehouse has on file a bond in the maximum penal sum. The assistant regional commissioner for the consignee premises will advise the assistant regional commissioner for the consignor premises of any subsequent change in the penal sum of the consignee's bond. The assistant regional commissioner of the consignor premises shall furnish one copy of the approved Form 1534 to the storekeeper-gauger at the consignor premises. The designated attorney-in-fact may thereafter execute Forms 236 covering transfers to the designated warehouse in the manner provided in § 221.612 and the storekeeper-gauger in charge at the distillery may approve such Forms 236.

(WWW) Section 221.615 is amended as follows:

(1) By striking from the third sentence, which begins "The details", the phrase "by the storekeeper-gauger".

(2) By striking from the last sentence the word "storekeeper-gauger" and inserting in lieu thereof the word "distiller".

(XXX) Section 221.622 is amended as follows:

(1) By striking from the second sentence, which begins "Where no", the phrase "to gauge and release" and inserting in lieu thereof the phrase "to supervise the gauging of and to release".

(2) By striking from the fifth sentence, which begins "The storekeeper-gauger", the word "storekeeper-gauger" and inserting in lieu thereof the word "distiller".

(3) By inserting, immediately after the fifth sentence, a new sentence, reading, "The distiller will deliver the forms to the storekeeper-gauger."

(YYY) Section 221.626 is amended by striking from the last sentence the word "storekeeper-gauger" and inserting in lieu thereof the word "distiller".

(ZZZ) Section 221.632 is amended as follows:

(1) By inserting in the first sentence, immediately after the phrase "in tank cars" the phrase "or tank trucks,".

(2) By striking from the first sentence the phrase "with the assistant regional commissioner".

(3) By inserting in the last sentence, immediately after the phrase "The tank cars" the phrase "or tank trucks".

(AAAA) Section 221.666 is amended by inserting, immediately after the phrase "and storekeeper-gaugers' " the phrase "and distillers' ".

(BBBB) Section 221.667 is amended by inserting in the first sentence, immediately following "Form 15,", the phrase "part 3,".

(CCCC) Section 221.713 is amended by striking from the last sentence the word "storekeeper-gauger's".

(DDD) Section 221.727 is amended by changing the first sentence to read, "The outgoing distiller will complete his record, Form 15, as to the transfer to the successor of materials in process, and as to production and removal from the distillery of all brandy produced by him."

(EEEE) Section 221.728 is amended as follows:

(1) By striking from the first sentence the phrase "materials, including those in process, received" and inserting in lieu thereof the phrase "materials in process received".

(2) By inserting in the last sentence, immediately after the words "If materials", the words "in process".

(FFFF) Section 221.743 is amended by inserting in the first sentence, immediately after the phrase "all materials", the phrase "in process".

(GGGG) Section 221.771 is amended by inserting, immediately after the phrase "the storekeeper-gaugers'", the phrase "and distillers'".

(HHHH) Section 221.772 is amended by inserting, immediately following "Form 15,", the phrase ", part 3,".

(IIII) By inserting a new section, reading as follows, immediately after § 221.773:

§ 221.773a OPERATING RECORDS.—Every proprietor of a fruit distillery who has distillates from two or more types of materials in process at the same time shall maintain such operating records in support of Form 15 as will permit the brandy to be traced through the various processes from the initial process of distillation to the deposit of the finished brandy in the receiving tanks. Such operating records shall show, by kind, proof, and proof gallons, the deposits in singlings and unfinished brandy tanks, charges to the various stills for redistillation, redeposits in unfinished brandy tanks, and other movements of the brandy. The operating records required by this section shall be kept available for inspection by internal revenue officers for not less than three years. (68A Stat. 637; 26 U. S. C. 5197)

(JJJJ) Section 221.781 is amended by inserting a comma immediately after the phrase "Form 15" in the second sentence of subparagraph (a) (3) and by striking the comma following the phrase "Forms 52–A and 52–B" in the same sentence.

(KKKK) Section 221.791 is amended by striking the phrase "No mash," and inserting in lieu thereof the phrase "Except as may be authorized in connection with the conduct of another business approved under the provisions of § 221.61, no mash,".

PAR. 3. 26 CFR (1954) part 225, Warehousing of Distilled Spirits, is amended as follows:

(A) Section 225.117 is amended by inserting in the fifth sentence, immediately after the phrase "in a concrete foundation", the phrase "at least twelve inches thick and".

(B) Section 225.261 is amended by striking from the first sentence the word "duplicate" and inserting in lieu thereof the word "triplicate".

(C) Section 225.262 is amended by striking the word "duplicate" where it appears in the first and second sentences and inserting in lieu thereof the word "triplicate".

(D) Section 225.316 is amended by striking from the first sentence the word "and" and inserting in lieu thereof a comma and by inserting at the end of the sentence the phrase "and one copy to the storekeeper-gauger in charge at the warehouse."

(E) By inserting, immediately after § 225.355, the following new section:

§ 225.355a EXCEPTION FOR WINDOWS.—Notwithstanding the provisions of § 225.355, assistant regional commissioners may, pursuant to letter application, authorize warehouse windows to be left open at night or on non-work days for necessary ventilation if, in the opinion of the assistant regional commissioner, the watchman service and lighting of the premises are adequate and other conditions are such that the open windows will not jeopardize the revenue.

(F) Section 225.373 is amended by striking from the first sentence the word "immediate".

(G) Section 225.376 is amended by striking from the last sentence the phrases "or spirits intended for exportation in tank cars," and "or 'For Exportation,' ".

(H) Section 225.377 is amended by striking the period at the end of the section and inserting in lieu thereof a colon and the following proviso:

Provided, That spirits of 190 degrees or more of proof, produced during different distilling seasons and years which are otherwise homogeneous may be mingled in storage tanks but such spirits may not be bottled in bond.

(I) Section 225.407 is amended by striking from the fifth sentence, which begins "The tare", the phrase "and will be marked on the package".

(J) Section 225.409 is amended by striking from the first sentence the words "the original proof gallons, the original proof and tare determined at time of filling, the date of original entry of the spirits for deposit, and the warehouse number and State in which located," and inserting in lieu thereof the words "the date of original entry of the spirits for deposit, the warehouse number and State in which located and except as provided in § 225.409a, the original proof gallons, the original proof and tare determined at the time of filling."

(K) By inserting the following new section immediately after § 225.409:

§ 225.409a OPTIONAL MARKING.—The markings on barrels with respect to proof gallons, proof and tare which are required or illustrated in §§ 225.409, 225.413, 225.417, 225.475, 225.611 may, at the option of the warehousemen, be omitted from the barrel if such barrel if filled to capacity and if there is shown in lieu of such markings the rated capacity, in gallons, of the barrel as prescribed by the manufacturing specifications. Where used, the rated capacity shall be in letters and figures not less than one-half inch in height and may be shown as "RC —— G." (68A Stat. 633; 26 U. S. C. 5193.)

(L) Section 225.412 is amended to read as follows:

§ 225.412 DETERMINING DATE OF ORIGINAL ENTRY.—Where distilled spirits are deposited in a warehouse storage tank on different dates, each lot so deposited and mingled shall retain its date of original entry for the purpose of determining the period of storage in bond and withdrawals shall be considered to be made on a first-in first-out basis.

(M) Section 225.424 is amended by adding at the end thereof the following new sentence:

Where distilled spirits are deposited and mingled in a warehouse storage tank as provided in § 225.377, each lot so deposited shall retain its date of original entry

for the purpose of determining the period of storage in bond and withdrawals shall be considered to be made on a first-in first-out basis.

(N) Section 225.565 is amended to read as follows:

§ 225.565 WITHDRAWAL ON ORIGINAL GAUGE.—Distilled spirits in packages, tank cars, and tank trucks filled from internal revenue bonded warehouse storage tanks may be withdrawn from an internal revenue bonded warehouse on the original gauge. Except as provided in § 225.491, distilled spirits in packages, tank cars, or tank trucks, filled at a distillery may be withdrawn from an internal revenue bonded warehouse on the original gauge only if the entry gauge was made by a storekeeper-gauger. Where the gauge was made pursuant to notification from the distiller that the spirits would be withdrawn on the original gauge, and the deposit forms for such spirits bear the notation "Withdrawn on the original gauge," the spirits must be withdrawn on the original gauge unless permission for a regauge is first obtained from the assistant regional commissioner.

(O) Section 225.584 is amended to read as follows:

§ 225.584 ADDITION OF BURNT SUGAR OR CARAMEL.—Where brandy is found to be unmerchantable owing to a deficiency in color, a small quantity of burnt sugar or caramel may be added to the brandy, either in packages or in the bulk gauging tank, after the brandy has been regauged for taxpayment and prior to the affixing of the wholesale liquor dealer's stamps to the packages or removal of the brandy from the bulk gauging tank. Burnt sugar or caramel may not be so added to any spirits other than brandy. The burnt sugar or caramel added to brandy shall not contain any substantial quantity of sugar which has not been caramelized, or possess any material sweetening properties. When the warehouseman desires to add burnt sugar or caramel to brandy he must file application in duplicate with the storekeeper-gauger in charge, showing the serial numbers of the packages or identifying the gauge tank, the name of the producing distillery, and the necessity for the addition of the burnt sugar or caramel to the brandy. If the application is in order the storekeeper-gauger in charge will approve the application and permit the addition, under his supervision, of the burnt sugar or caramel. The original copy of the approved application will be retained by the storekeeper-gauger and the duplicate returned to the applicant. Packages containing brandy to which burnt sugar or caramel has been added, in addition to all other marks and brands required by this part, shall be branded with the letters "B. S. A." A similar notation shall be made on the regauge form covering brandy to which caramel has been added in the bulk regauging tank. (68A Stat. 607, 639; 26 U. S. C. 5025, 5212)

(P) Section 225.632 is amended by striking from the ninth sentence, which begins "After the packages", the phrase "kind of cooperage,".

(Q) By inserting, immediately following § 225.734, the following new section:

§ 225.734a FORMS 236 ORIGINATING AT CONSIGNOR PREMISES.—Where spirits are to be transferred in bond to an internal revenue bonded warehouse operated by the warehouseman, or an affiliate or subsidiary of the warehouseman, in the same region and the receiving warehouse has on file a bond in the maximum penal sum of $200,000, the consignee warehouseman may designate an agent or employee of the consignor warehouseman as an attorney-in-fact to execute Form 236 for the consignee warehouseman. The consignee warehouseman shall file letter application with the assistant regional commissioner for permission to establish such procedure, together with power of attorney on Form 1534, in triplicate, executed as provided in § 225.163, authorizing an individual at the consignor premises to execute Form 236 for the consignee warehouseman. If the assistant regional commissioner approves the application, he shall so notify the applicant and furnish the storekeeper-gauger in charge at the consignor premises a copy of the approved Form 1534 on which he has noted the fact that the consignee warehouse has on file a bond in the maximum penal sum. The assistant regional commissioner will advise the storekeeper-gauger of any subsequent change in the penal sum of the consignee's bond. The designated attorney-in-fact may thereafter execute Forms 236 covering transfers to the designated warehouse in the manner provided in § 225.733 and the storekeeper-gauger in charge at the consignor warehouse may approve such Forms 236.

(R) Section 225.735 is amended by inserting, immediately after the fifth sentence, which begins "The storekeeper-gauger", the following new sentence, "If the deposit forms for any of the packages included on the Forms 236 and 1619 bear the notation 'Taxpay on original gauge' the storekeeper-gauger shall identify such packages on the Form 1619 by a similar notation."

(S) Section 225.742 is amended by inserting in the first sentence, immediately after the phrase "for use in the preparation of wine,", the phrase "or to transport spirits for exportation,".

(T) By inserting, immediately after § 225.753, the following new section:

§ 225.753a FORMS 236 ORIGINATING AT CONSIGNOR PREMISES.—Where spirits are to be transferred in bond to an internal revenue bonded warehouse operated by the warehouseman, or an affiliate or subsidiary of the warehouseman, located in a different region and the receiving warehouse has on file a bond in the maximum penal sum of $200,000, the consignee warehouseman may designate an agent or employee of the consignor warehouseman as an attorney-in-fact to execute Form 236 for the consignee warehouseman. The consignee warehouseman shall file letter application with the assistant regional commissioner for permission to establish such procedure, together with power of attorney on Form 1534, in quadruplicate, executed as provided in § 225.163, authorizing an individual at the consignor premises to execute Form 236 for the consignee warehouseman. If the assistant regional commissioner approves the application, he shall so notify the applicant and furnish the assistant regional commissioner of the region in which the consignor warehouse is located two copies of the approved Form 1534 on which he has noted the fact that the consignee warehouse has on file a bond in the maximum penal sum. The assistant regional commissioner for the consignee premises will advise the assistant regional commissioner for the consignor premises of any subsequent change in the penal sum of the consignee's bond. The assistant regional commissioner of the consignor premises shall furnish one copy of the approved Form 1534 to the storekeeper-gauger at the consignor premises. The designated attorney-in-fact may thereafter execute Forms 236 covering transfers to the designated warehouse in the manner provided in § 225.752 and the storekeeper-gauger in charge at the consignor warehouse may approve such Forms 236.

(U) Section 225.770 is amended by striking from the third sentence, which begins "Spirits for redistillation", the phrase "an approved application" and inserting in lieu thereof the phrase "Form 236".

(V) Section 225.771 is amended as follows:

(1) By striking from the first sentence the phrase "and the copy of the special application authorizing the removal,".

(2) By striking the second sentence.

(3) By striking from the third sentence the word "He" and inserting in lieu thereof the words "The storekeeper-gauger".

(4) By changing the period at the end of the tenth sentence to a colon and adding the following:

Provided, That where containers of spirits are removed to a distillery on the same or contiguous premises for prompt redistillation, the transfer-in-bond markings and the words "For Redistillation" need not be placed on the containers.

(5) By striking from the eleventh sentence, which begins "The storekeeper-gauger will note", the comma in the phrase " 'For Redistillation,' " and inserting in lieu thereof a period and striking the remainder of the sentence.

(6) By striking the last sentence.

(W) Section 225.781 is amended by changing item (e) to read, "in tank cars or tank trucks filled at the distillery or from warehouse storage tanks;".

(X) Section 225.791 is amended by striking the phrase "need not be accompanied by an export bond" and inserting in lieu thereof the phrase "will be submitted to the storekeeper-gauger in charge".

(Y) Section 225.797 is amended as follows:

(1) By changing the headnote to read "APPROVAL OF BOND AND APPLICATION BY ASSISTANT REGIONAL COMMISSIONER."

(2) By inserting in the last sentence, immediately after the phrase "the assistant regional commissioner shall" the phrase ", except where the application is submitted to the storekeeper-gauger in charge,".

(Z) By inserting, immediately following § 225.797, a new section reading as follows:

§ 225.797a APPROVAL OF APPLICATION BY STOREKEEPER-GAUGER.—Where the owner of the spirits has on file with the assistant regional commissioner a continuing bond on Form 657 or Form 658 and, pursuant to § 225.791, the application is submitted to the storekeeper-gauger in charge, that officer shall, if the owner and proprietor of the warehouse have complied with the law and this part and the application is complete in all respects, execute the permit for removal and transportation of the spirits on all copies of Form 206. (68A Stat. 647; 26 U. S. C. 5247.)

(AA) Section 225.798 is amended by striking from the first sentence the phrase "Upon receipt by the storekeeper-gauger of Form 206 with the permit executed by the assistant regional commissioner," and inserting in lieu thereof the phrase "Upon notification by the storekeeper-gauger that the permit to export has been executed,".

(BB) Section 225.817 is amended by striking from the last sentence the phrase "the application need not be accompanied by a bond if the applicant has on file with the assistant regional commissioner an approved continuing bond (Form 657 or 658) in a sufficient penal sum." and inserting in lieu thereof the phrase "when an approved continuing bond (Form 657 or 658), in a sufficient penal sum, if on file in the assistant regional commissioner's office, applications covering exportations thereunder will be submitted to the storekeeper-gauger in charge."

(CC) Section 225.818 is amended as follows:

(1) By changing the headnote to read "APPROVAL OF BOND AND APPLICATION BY ASSISTANT REGIONAL COMMISSIONER."

(2) By striking the second sentence, which begins "In cases where".

(3) By inserting in the last sentence, immediately after the phrase "the assistant regional commissioner shall,", the phrase "except where the application is submitted to the storekeeper-gauger,".

(DD) By inserting, immediately after § 225.818, the following new section:

§ 225.818a. APPROVAL OF APPLICATION BY STOREKEEPER-GAUGER.—Where the owner of the spirits has on file with the assistant regional commissioner a continuing bond on Form 657 or Form 658 and, pursuant to § 225.817, the application is submitted to the storekeeper-gauger in charge, that officer shall, if the

owner and the proprietor of the warehouse have complied with the law and this part and the application is complete in all respects, execute the permit for removal and transportation of the spirits on all copies of Form 206. (68a Stat. 647; 26 U. S. C. 5247)

(EE) Section 225.819 is amended by striking from the first sentence the phrase "Upon receipt of Form 206, approved by the assistant regional commissioner," and inserting in lieu thereof the phrase "Upon approval of Form 206,".

(FF) By inserting, immediately after § 225.838, the following new section:

§ 225.838a STOREKEEPER-GAUGER'S ACCOUNT WITH EXPORT BONDS, FORMS 657 AND 658.—The storekeeper-gauger in charge of a warehouse having on file an approved continuing export bond on Form 657 or 658 will keep an account on Form 1688 of such bond in the manner prescribed by § 225.838. The assistant regional commisisoner will, upon approving a bond on Form 657 or 658, furnish the storekeeper-gauger a Form 1688 on which all information in the heading has been inserted and will, from time to time as circumstances indicate, advise the storekeeper-gauger of credits which may be made in the account. (68A Stat. 647; 26 U. S. C. 5247)

(GG) Section 225.843 is amended as follows:

(1) By inserting, immediately after the phrase "in any internal revenue", the word "bonded".

(2) By inserting, immediately after the phrase "to tank cars", the phrase "or tank trucks".

(HH) Section 225.844 is amended as follows:

(1) By striking from the first sentence the phrase "pursuant to the above provisions of law," and inserting in lieu thereof the phrase "or tank trucks,".

(2) By inserting in the second sentence immediately after the phrase "The tank cars", the phrase "or tank trucks".

(3) By inserting in two places in the third sentence, immediately after the words "tank car", the words "or tank truck".

(4) By inserting at the end of the section a new sentence reading, "The use of tank trucks for exportation of distilled spirits shall be subject to the applicable provisions of §§ 225.740–225.743."

(II) Section 225.845 is amended as follows:

(1) By striking from the first sentence the phrase "assistant regional commissioner with whom export withdrawal entries are filed" and inserting in lieu thereof the phrase "storekeeper-gaugers in charge of premises from which such spirits are withdrawn".

(2) By striking from the last sentence the phrase "in typewritten form on official letterheads." and inserting in lieu thereof the phrase "on Form 2177."

(3) By adding at the end of the section the following new sentence:

Form 2177 may also be isued for distilled spirits removed to a foreign-trade zone, in which case the number and location of the foreign-trade zone will be shown on the form in lieu of the name of the foreign country.

(JJ) Section 225.862 is amended by changing the last sentence to read as follows:

Insofar as applicable the procedure prescribed in §§ 225.817 to 225.819 relating to the transfer and withdrawal of spirits bottled in bond for exportation, is

hereby extended to cover the transfer and withdrawal of bottled spirits free of tax for use as supplies on vessels or aircraft, except that where the spirits are for use on aircraft, application on Form 206 shall be executed in quintuplicate and shall show the name of the airline operating the aircraft and the name and location of the airport from which the aircraft will depart in international travel, and one copy of the Form 206 shall be marked "Consignee's copy".

(KK) Section 225.864 is amended as follows:

(1) By inserting in the first sentence, immediately following the words "with the collector of customs", the words "and, in the case of spirits withdrawn for use on aircraft, must forward or deliver the copy of Form 206, prepared and marked for the consignee in accordance with the provisions of § 225.862, to the airline company at the airport".

(2) By inserting in the list of sectional references in the second sentence, in its proper numerical sequence, a reference to section "225.865a."

(LL) Section 225.865 is amended as follows:

(1) By inserting at the end of the headnote the words "*on vessels*".

(2) By striking from the first sentence, wherever they appear, the phrases "or aircraft" and "or supplies for aircraft".

(MM) By inserting, immediately after § 225.865, the following two new sections:

§ 225.865a DISTILLED SPIRITS FOR USE AS SUPPLIES ON AIRCRAFT.—All distilled spirits withdrawn for use as supplies on aircraft will be consigned to the airline at the airport from which the aircraft will depart in international travel, in care of the collector of customs. Upon receipt of the distilled spirits they will be stored at the airport under customs custody until laden as supplies on aircraft. When an airline desires to withdraw distilled spirits from its stock being held at the airport under customs custody, as supplies for a particular aircraft, a requisition in triplicate will be prepared for presentation to the customs officer. The requisition shall show the flight number, the registry number of the aircraft on which the distilled spirits are to be laden, the date of departure of the aircraft, and the brand, kind, and quantity of distilled spirits. Where the distilled spirits are contained in kits which have been previously prepared while the distilled spirits are under customs custody, the kit number will also be shown on the requisition. Where the kits are not prepared and the distilled spirits are withdrawn for direct lading on aircraft, the requisitions shall be serially numbered in lieu of the insertion of the kit number. When the distilled spirits are withdrawn and laden aboard the aircraft, the lading will be verified by the customs officer by an appropriate stamp or notation on the requisition. One copy of the requisition will be retained by the customs officer who certifies to the lading for attachment to the outgoing manifest. The other two copies will be delivered to the airline which will retain both copies until the return of the flight. In case any distilled spirits are removed from the aircraft upon its return, appropriate notation will be made on both copies of the requisition retained by the airline and one copy will be delivered to the customs officer for attachment to the incoming manifest. The remaining copy will be retained by the airline.

§ 225.865b CERTIFICATE OF USE FOR DISTILLED SPIRITS USED AS SUPPLIES ON AIRCRAFT.—When all of the distilled spirits represented by any Form 206 have been withdrawn from customs custody, and laden and used as supplies on aircraft, the airline will prepare a certificate of use on which are itemized all requisitions for such distilled spirits. The certificate shall show the name of the exporter, the entry number, the brand and kind of spirits, and the number of bottles to be accounted for; and, as to each requisition, the requisition (or kit) number, the date laden, the registry number of the aircraft, the country for

which the aircraft was cleared, and the number of bottles used. The certificate shall be in substantially the following form:

Name of Exporter _____
Entry No. _____
Brand and kind of spirits _____
No. of bottles to be accounted for _____

Number of requisition (or kit number)	Date laden	Registry number of aircraft	Cleared for (country)	Number of bottles used [1]

[1] The number of bottles shown in this column will represent the difference between the number withdrawn for supplies and the number returned unused as shown by the requisition.

CERTIFICATE OF USE

I hereby certify that the above described distilled spirits were withdrawn from stock in customs custody and were laden for use as supplies on aircraft as set forth and that the records of the aircraft show such distilled spirits were used outside the continental limits of the United States as supplies on aircraft operated by this company in international travel.

_____
(Airline company)

By _____

_____
(Capacity)

When the form has been completed as to all distilled spirits laden and used as supplies, the certificate of use will be executed by the authorized representative of the airline. The form will be presented to the customs officer at the airport who, upon verification with the requisitions previously verified, will certify the form by appropriate notation and execute his certificate of inspection and lading on Form 206, noting thereon exceptions, if any, such as shortages, breakage, etc. The customs officer will forward both copies of Form 206, with the certificate of use attached to the original, to the collector of customs, who will execute his certificate on Form 206 and forward the original, with the certificate of use attached, to the assistant regional commissioner who approved it.

(NN) Section 225.866 is amended by inserting at the end thereof a new sentence reading, "In the case of spirits laden on aircraft, credit will be given at the time the spirits are accounted for in conformity with the requirements of § 225.865b."

(OO) Section 225.877 is amended as follows:

(1) By striking the word "The" at the beginning of the fourth sentence and inserting in lieu thereof the following: "Except where an approved continuing bond on Form 1618, in a sufficient penal sum, is on file in the assistant regional commissioner's office, the".

(2) By inserting at the end of the section the following new sentence: "Where an approved continuing bond on Form 1618 is on file in the assistant regional commissioner's office, the application shall be submitted to the storekeeper-gauger in charge for approval."

(PP) By inserting, immediately after § 225.878, the following new section:

§ 225.878a STOREKEEPER-GAUGER'S ACCOUNT WITH CONTINUING BOND, FORM 1618.—The storekeeper-gauger in charge of a warehouse having on file an approved continuing bond on Form 1618 covering transfers of liquors to customs

manufacturing bonded warehouses will keep an account on Form 1687 of such bond in the manner prescribed by § 225.878. The assistant regional commissioner will, upon approving a bond on Form 1618, furnish the storekeeper-gauger a Form 1687 on which all information in the heading has been inserted and will, from time to time as circumstances indicate, advise the storekeeper-gauger of credits which may be made in the account. (68A Stat. 604, 679; 26 U. S. C. 5011, 5522.)

(QQ) By inserting, immediately after § 225.955 the following new section:

§ 225.956 Bottling a Part of a Lot for Exportation.—A warehouseman may bottle for exportation a part of a lot of spirits dumped for domestic bottling in bond. The application on Form 1515, as required by §§ 225.951 and 225.953, shall be modified to show that the spirits are to be withdrawn for bottling in bond for domestic purposes and for exportation and the quantity of spirits intended for exportation shall be indicated. Upon completion of bottling the storekeeper-gauger will enter the details of the cases on Form 1515 showing, as a separate entry, the serial numbers of those cases of spirits intended for exportation and the proof of the spirits contained therein. The procedure prescribed in §§ 225.950–225.955 shall be observed insofar as applicable.

(RR) Section 225.966 is amended by inserting, immediately after the fifth sentence, which begins, "Adjusting the proof", a new sentence reading, "When a part of a lot of spirits dumped for domestic bottling-in-bond is to be bottled for exportation, as provided in § 225.956, such quantity may be further reduced in proof and filtered if necessary."

(SS) Section 225.971 is amended by changing the period at the end of the second sentence, which begins, "If the spirits", to a colon and adding the following:

Provided, That where a lot of spirits is deposited in more than one bottling tank, or a part of a lot is transferred to another tank, Form 1515 will be attached to one of the tanks and will be marked to show the serial numbers of the other tanks in which the spirits were deposited. Such other tanks will be marked to show the serial number of the Form 1515 pursuant to which the contents thereof were withdrawn for bottling. The quantity deposited in each bottling tank shall be entered on Form 1515.

(TT) Section 225.972 is amended as follows:

(1) By inserting, immediately after the second sentence, which begins, "Prior to", the following two new sentences:

Where, as provided in § 225.956, a part of a lot of spirits is to be bottled for exportation, the quantity to be so bottled may be deposited in a separate bottling tank. In such case, the proof and quantity in each tank will be entered on Form 1515.

(2) By changing the period at the end of the third sentence to a colon and adding the following:

Provided, That when the remaining part of a lot of spirits is to be bottled for exportation, as provided in § 225.956, the inlet of the bottling tank may be opened prior to completion of bottling to permit the addition of pure water for reduction in proof of those spirits intended for exportation.

(UU) Section 225.975 is amended by inserting, immediately after the first sentence, the following new sentence:

Where a lot of spirits is bottled in part for domestic purposes and in part for exportation, as provided in § 225.956, the total loss or gain for the combined operation shall be entered on Form 1515.

(VV) Section 225.1060 is amended as follows:

(1) By striking from the first sentence the phrase "the assistant regional commissioner of the region in which the work is to be per-

formed." and inserting in lieu thereof the phrase "the storekeeper-gauger in charge of the warehouse."

(2) By striking from the fourth sentence, which begins "Warehousemen and", the words "Warehousemen and assistant regional commissioners will bear in mind that the" and inserting in lieu thereof the word "The".

(WW) Section 225.1061 is amended to read as follows:

§ 225.1061 EXAMINATION OF SPIRITS.—Upon receipt of such application, the storekeeper-gauger in charge at the warehouse will examine the condition of the spirits and verify the data contained in the application.

(XX) Section 225.1062 is amended as follows:

(1) By striking from the first, second, and third sentences the words "assistant regional commissioner" and inserting in lieu thereof the word "storekeeper-gauger".

(2) By striking from the first sentence the word "reconditioning".

(3) By striking from the third sentence the words "Director, Alcohol and Tobacco Tax Dixision," and inserting in lieu thereof the words "assistant regional commissioner".

(4) By inserting at the end of the section the following new sentence:

The storekeeper-gauger will make a full report of his inspection, and of the action taken on the application, to the assistant regional commissioner.

(YY) Section 225.1065 is amended by striking the last sentence.

(ZZ) Section 225.1103 is amended as follows:

(1) By striking the last sentence and inserting in lieu thereof the following new sentences:

Where two or more lots of spirits are deposited in the same storage tank, withdrawals shall be charged in red against the deposit entry (Form 1520) on a first-in first-out basis and when a quantity equivalent to that covered by such deposit entry has been withdrawn or otherwise accounted for the form shall be noted accordingly and shall then be removed to an inactive file. When a storage tank is emptied the storekeeper-gauger shall note on the last deposit entry the date the tank was emptied.

(2) By changing the citation of authority following the section to read "(68A Stat. 644; 26 U. S. C. 5241)."

(AAA) Section 225.1126 is amended by striking from the sixth sentence, which begins "The proprietor shall", the phrase "part 2 of Form 52C, in duplicate," and inserting in lieu thereof the phrase "Form 52C (original)".

(BBB) Section 225.1140 is amended as follows:

(1) By striking from the first sentence the word "triplicate" and inserting in lieu thereof the word "duplicate".

(2) By striking from the last sentence the words "and one copy".

(3) By striking from the last sentence the word "remaining" and inserting in lieu thereof the word "duplicate".

(CCC) Section 225.1141 is revoked.

Because it is necessary to provide regulations which will enable distilleries to operate with less supervision by Government officers, it is hereby found impracticable to issue this Treasury decision subject to

the effective date limitations of section 4(c) of the Administrative Procedure Act (60 Stat. 238; 5 U. S. C. 1003 (c)). Accordingly, this Treasury Decision shall be effective on the date of publication in the Federal Register, except that the provisions of part 220 (sections 258, 280, 282, 283, 290, 292, 293, 367, 379, 435, 451, 662, 712, 713, 723 and 756) and of part 221 (sections 254, 263, 292, 293, 300, 302, 303, 355, 357, 362, 384, 427, 437, 466, 667, 728, 743 and 772) as they relate to the keeping of records and rendering of returns on Forms 1598 and 15 shall be effective on the first day of the first month which begins not less than 30 days following the date of publication in the Federal Register.

(This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U. S. C. 7805).)

RUSSELL C. HARRINGTON,
Commissioner.

Approved: December 28, 1955.

H. CHAPMAN ROSE,
Acting Secretary of the Treasury.

(Published in the Federal Register January 10, 1956)

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26 CFR 220.489: Disposition of samples.

For clarification of the permissible and prohibited uses and disposition of samples of distilled spirits withdrawn from distilleries, internal revenue bonded warehouses and bonded wine cellars, see Rev. Proc. 56–19, page 1043.

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26 CFR 221.60: Restrictions.

The conduct of business other than the production of alcoholic beverages on distillery premises. See T. D. 6159, page 758.

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26 CFR 225.117: Storage tanks outside warehouse building.

Construction of permanent tanks outside warehouse buildings for the storage of distilled spirits. See T. D. 6159, page 758.

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26 CFR 225.534: Limitation on number, size, and use of samples of distilled spirits other than brandy or wine spirits. Rev. Rul. 56–97

Section 225.534 of the Regulations relating to the Warehousing of Distilled Spirits makes provision for the taking of samples, by the proprietor of an internal revenue bonded warehouse, from tank cars or tank trucks of distilled spirits received in bond. No specific provision is made for the taking of samples from tank cars and tank trucks of distilled spirits removed for shipment in bond. *Held*, the taking of samples from tank cars and tank trucks of distilled spirits removed for shipment in bond is analogous to the taking of samples from tank

cars and tank trucks received in bond, and is permitted within the limitations as to number, size, and use, specified in section 225.534 of the regulations.

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26 CFR 225.860: General.

Tax-free withdrawal of distilled spirits from internal revenue bonded warehouses as supplies for fishing vessels. See T. D. 6180, page 753.

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26 CFR 240.690: Withdrawal free of tax.

Tax-free withdrawal of wine from bonded wine cellars as supplies for fishing vessels. See T. D. 6180, page 753.

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26 CFR 245.290: General.

Tax-free withdrawal of beer from breweries as supplies for fishing vessels. See T. D. 6180, page 753.

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26 CFR 252.3: Supplies upon certain vessels and aircraft. T. D. 6181[1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER E, PART 252.—DRAWBACK ON LIQUORS EXPORTED

Part 252 of Title 26 of the Code of Federal Regulations amended in regard to (1) supplies on vessels employed in the fisheries to conform with Customs regulations, and (2) the exportation of taxpaid beer.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On July 28, 1955, a notice of proposed rulemaking with respect to the amendment of the above-entitled regulations was published in the Federal Register (20 FR 5400) to conform such regulations with the Bureau of Customs regulations as amended by Treasury Decision 53935 (20 FR 8329) to define the types of vessels employed in the fisheries which are entitled to withdraw distilled spirits, wines, and beer for use as supplies on such vessels, pursuant to section 309(a) of the Tariff Act of 1930 (19 U. S. C. 1309(a)).

No data, views, or arguments were received within the period of 30 days from the date of such publication.

The amendments of 26 CFR Part 252 as set forth below are hereby adopted:

PARAGRAPH 1. Section 252.3 is amended by inserting immediately following the word "fisheries" in paragraphs (b) and (e), the phrase: "as provided in § 252.3a".

PAR. 2. Immediately following § 252.3, the following new section is added:

[1] 21 F. R. 3929.

§ 252.3a VESSELS EMPLOYED IN THE FISHERIES.—Distilled spirits, wines, and beer may be shipped and laden with benefit of drawback on fishing vessels under the provisions of paragraphs (b) and (e) of § 252.3 only for use on vessels of the United States documented to engage in the fisheries and foreign fishing vessels of 5 net tons or over if the Collector of Customs is satisfied by reason of the quantity requested, in the light of (1) whether the vessel is employed in substantially continuous fishing activities, and (2) the vessel's complement, that none of the withdrawn articles is intended to be removed from the vessel in, or otherwise returned to, the United States. Such shipment and lading shall be conditioned upon compliance with the applicable provisions of this part. Lading of such articles for use on such vessels shall be subject to approval by the Collector of Customs of a special written application, in duplicate, on Customs Form 5125, of the exporter and designation by the applicant in part 1 of the notice Form 1582, 1582-A or 1582-B, as the case may be, that the articles are to be laden for use as supplies on a vessel employed in the fisheries. The original application on Customs Form 5125, after approval, shall be stamped with the withdrawal number (entry number on Form 1582, 1582-A or 1582-B) and date thereof and shall be returned by the Collector of Customs to the exporter for use as prescribed below. Approval of each such application shall be subject to the condition that the original shall be presented thereafter by the exporter or the vessel's master to the Collector of Customs within 24 hours (excluding any period during which the customhouse is not open for general customs business) after each subsequent arrival of the vessel at a customs port or station and that an accounting shall be made at the time of such presentation of the disposition of the articles until the Collector of Customs is satisfied that all of them have been consumed on board, or landed under customs supervision, and takes up the authorization. The approval of Customs Form 5125 shall be subject to the further condition that any such withdrawn articles remaining on board while the vessel is in port shall be safeguarded in the manner and to such extent as the collector for the port or place of arrival shall deem necessary. When such articles have been accounted for to the satisfaction of the Collector of Customs, he shall so certify on the completed Customs Form 5125 taken up from the exporter or the vessel's master and forward the form to the Assistant Regional Commissioner for the region in which the claim for drawback is required to be filed. In the event of a failure on the part of the exporter or the master of the vessel to comply with the conditions of the application or upon receipt of evidence that the articles were not lawfully used as supplies on the vessel, the Collector of Customs will advise the Assistant Regional Commissioner for the region in which the claim for drawback is required to be filed of all the facts in the case for determination as to whether to make demand upon the principal and the surety on the bond in accordance with the provisions of § 252.125, or to disallow the claim, as the case may be.

PAR. 3. Section 252.41 is amended to read as follows:

§ 252.41 GENERAL.—Whenever, as to any shipment, a certificate of foreign landing, as provided by § 252.114, is required by the assistant regional commissioner on an affidavit as to lading and intended use is required under the provisions of § 252.115, or an accounting of the spirits or wines is required as provided in § 252.3a, and the exporter desires drawback on the shipment of distilled spirits or wines under the provisions of this subpart prior to submission of such certificate or affidavit to the Assistant Regional Commissioner, or accounting for the distilled spirits or wines as provided in § 252.3a, he shall file bond in accordance with the provisions of this subpart.

PAR. 4. Section 252.43 is amended by striking the period at the end thereof and adding the following: "or, in the case of withdrawals for supplies on vessels employed in the fisheries, until the original of Customs Form 5125, bearing final certification by the Collector of Customs as to proper accounting of the spirits or wines is submitted as required in § 252.3a."

PAR. 5. The second sentence of § 252.45, which begins "The liability under", is amended by striking the comma at the end of the phrase "lading for use on vessels," and inserting the following: "(or, in the case of spirits or wines laden for use on vessels employed in the fish-

eries, the original of Customs Form 5125 bearing final certification by the Collector of Customs as to proper accounting of such articles),".

PAR. 6. The second sentence of § 252.48, which begins "Credit will be given", is amended by striking the comma at the end of the phrase "supplies on vessels," and inserting the following: "(or, in the case of spirits or wines laden for use on vessels employed in the fisheries, original of Customs Form 5125 bearing final certification by the collector of customs as to proper accounting for such articles),".

PAR. 7. Section 252.115 is amended to read as follows:

§ 252.115 EVIDENCE OF USE AS SUPPLIES ON VESSELS.—If the spirits or wines were laden on board a vessel for use as ship's supplies, there must be submitted promptly to the Assistant Regional Commissioner with whom the claim is filed, a statement of the master or other officer of the vessel on which the articles were laden, having knowledge of the facts, showing that the spirits or wines have been laden and will be used on board the vessel, and that no portion thereof has been or will be landed in the United States or any of its possessions: *Provided*, That such statement will not be required, in the case of any shipment, when the distilled spirits or wines are laden on vessels of war or, in cases other than supplies on vessels employed in the fisheries, where the amount of tax on the distilled spirits or wines does not exceed $100. Such statement shall be signed by the master or other officer having knowledge of the facts and immediately above the signature there will appear the following statement: "I declare under the penalties of perjury that this statement has been examined by me and to the best of my knowledge and belief is true and correct." In the case of vessels employed in the fisheries, compliance with the provisions of § 252.3a is required.

PAR. 8. Section 252.119 is amended as follows:

(A) By inserting, immediately following "for use on vessels,", the following: "compliance with § 252.3a,"; and

(B) By striking the period at the end of the section and adding: ", and, where required under the provisions of § 252.3a, accounting for such spirits or wines shall be eccomplished within such time as the collector of customs shall consider reasonable."

PAR. 9. The first sentence of § 252.121 is amended as follows:

(A) By inserting, immediately following "vessels or aircraft,", the following: "or an accounting of the spirits or wines,"; and

(B) By inserting, immediately following "provisions of this subpart,", the following: "or § 252.3a,".

PAR. 10. Section 252.122 is amended as follows:

(A) By inserting in the first sentence, immediately following "supplies on vessels,", the following: "or to account for the distilled spirits or wines where required by § 252.3a,"; and

(B) By inserting in the third sentence, which begins "The application shall", immediately following "for use as supplies", the following: "(or accounting for the spirits or wines)".

PAR. 11. Section 252.124 is amended to read as follows:

§ 252.124 APPROVAL OF RELIEF APPLICATION.—If the Assistant Regional Commissioner is satisfied from the evidence presented that the spirits or wines were duly exported from the United States and were landed at the designated foreign port or, for a good and sufficient reason, at some other port outside the jurisdiction of the United States, or were laden as supplies on vessels or were, in the case of spirits or wines laden as supplies on vessels employed in the fisheries, consumed or lost at sea and not relanded in the United States, its territories or possessions, and that the failure of the applicant to furnish the prescribed evidence of landing, or lading for use as supplies on vessels, or to account for the spirits or wines when required by § 252.3a, was not occasioned by any lack of diligence on his part or that of his agents, and, in the case of supplies on vessels employed in the fisheries, the master of the vessel, and that the applicant

is unable to produce any other or better evidence than that submitted with the application, he will indorse his approval on the application, and enter proper credit in the account kept with the drawback bond or allow the claim, as the case may be.

PAR. 12. The first sentence of § 252.125 is amended as follows:

(A) By inserting, immediately following "for use as supplies,", the following: "or the spirits or wines are not accounted for,"; and

(B) By striking the comma at the end of the phrase "as required in this subpart," and inserting: "or § 252.3a,".

PAR. 13. Section 252.151 is amended to read as follows:

§ 252.151 AUTHORIZED WITHDRAWALS.—Taxpaid beer, brewed or produced in the United States, may be withdrawn by the owner of the beer from a brewery or any other place of storage for exportation or for use as supplies on vessels or aircraft. Claim for drawback of taxes found to have been paid may be filed only by the producing brewer or his duly authorized agent.

PAR. 14. Section 252.152 is amended as follows:

(A) By striking, in the first sentence, the words: "Entry No. —," and, "and the port of exportation"; and

(B) By striking the second sentence which begins: "The entry number assigned".

PAR. 15. The undesignated center heading preceding § 252.153 and § 252.153 are amended to read as follows:

CLAIM REQUIRED

§ 252.153 BEER EXPORTED, DEPOSITED IN FOREIGN-TRADE ZONES, OR USED AS SUPPLIES ON VESSELS OR AIRCRAFT.—Claim for allowance of drawback of internal revenue taxes on beer brewed or produced in the United States shall be prepared on Form 1582–B as required in this subpart.

PAR. 16. The undesignated center heading preceding § 252.154 and § 252.154 are amended to read as follows:

EXECUTION OF CLAIM

§ 252.154 WITHDRAWALS OF BEER BY BREWER FROM BREWERY.—When taxpaid beer is removed from a brewery for exportation, for lading as supplies on vessels or aircraft, or for deposit in a foreign-trade zone, the brewer will execute part 1 and part 3 of Form 1582–B, in triplicate. Each Form 1582–B shall be given a serial number beginning with "1" for the first day of January of each year and running consecutively thereafter to December 31, inclusive. Upon removal of the beer for shipment the brewer will immediately file one copy of Form 1582–B with the Assistant Regional Commissioner of the region in which the producing brewery is located, and:

(a) Immediately forward the original and one copy of Form 1582–B to the Collector of Customs at the port of export; or,

(b) In the case of shipments to the Armed Services of the United States for export, immediately forward the original and one copy of Form 1582–B to the commanding or supply officer to whom the shipment is consigned; or,

(c) In the case of shipments to a foreign-trade zone, immediately forward the original and one copy of Form 1582–B to the customs officer in charge of the foreign-trade zone.

Where the brewer operates more than one brewery in different regions, the brewer will file the copy of Form 1582–B on which the claim for drawback is executed with the Assistant Regional Commissioner of the region in which the principal office of the brewery is located.

PAR. 17. Immediately following § 252.154, a new § 252.154a is added, which reads as follows:

§ 252.154a REMOVALS OF BEER BY AGENT ON BEHALF OF BREWER.—Where proper power of attorney authorizing an agent to execute a claim on behalf of

the brewer has been filed on Form 1534 with the assistant regional commissioner, such agent may remove taxpaid beer from the brewery where produced or from its place of storage elsewhere, and execute part 1 and part 3 of Form 1582–B on behalf of the brewer. Each Form 1582–B shall be given a serial number beginning with "1" for the first day of January of each year and running consecutively thereafter to December 31, inclusive. Such agent will prepare and dispose of Form 1582–B in accordance with the applicable procedure set forth in § 252.154.

PAR. 18. Section 252.155 is amended to read as follows:

§ 252.155 REMOVALS OF BEER BY PERSONS OTHER THAN THE BREWER OR HIS AGENT.—Where there is a removal of taxpaid beer by a person other than the brewer or the agent of the brewer for export, or for supplies on vessels or aircraft, or for deposit in a foreign-trade zone, such person shall execute part 1 of Form 1582–B, in triplicate. Where the exportation consists of the products of more than one brewer, a separate Form 1582–B must be prepared for the products of each brewer. Each Form 1582–B shall be given a serial number beginning with "1" for the first day of January of each year and running consecutively thereafter to December 31, inclusive. Information called for shall be furnished in accordance with the instructions on the form or issued in respect thereto. Upon removal of the beer for shipment such person will immediately forward one copy of Form 1582–B to the producing brewer, and:

(a) Immediately forward the original and one copy of Form 1582–B to the Collector of Customs at the port of export; or,

(b) In the case of shipments to the Armed Services of the United States for export, immediately forward the original and one copy of Form 1582–B to the commanding or supply officer to whom the shipment is consigned; or,

(c) In the case of shipments to a foreign-trade zone, immediately forward the original and one copy of Form 1582–B to the customs officer in charge of the foreign-trade zone.

Upon receipt of the copy of Form 1582–B from the exporter, the brewer will, if he wishes to claim drawback on the beer covered thereby, execute the claim for drawback on part 3 of the form and file the claim with the Assistant Regional Commissioner of his region. Where the claim is not filed with the Assistant Regional Commissioner within six months after the date shown in the certificate of removal in part 1 of the form, the applicable provisions of §§ 252.166 to 252.169, relating to evidence of exportation or lading for use on vessels and aircraft shall apply.

PAR. 19. Section 252.157 is amended to read as follows:

§ 252.157 DIRECT DELIVERY FOR CUSTOMS INSPECTION; BILL OF LADING.—If the premises from which the shipment is made are located at the port of exportation, the beer shall be delivered directly for customs inspection and supervision of lading, and a copy of the export bill of lading shall be promptly forwarded to the Assistant Regional Commissioner of the region in which the claim for drawback is filed: *Provided*, That an export bill of lading will not be required, (a) in the case of shipments to the Armed Services, where the shipment will be delivered to the commanding officer or supply officer to whom consigned, or (b) in the case of shipment for lading for use as supplies on vessels or aircraft.

PAR. 20. Section 252.158 is amended to read as follows:

§ 252.158 EXPORTATION BY VESSEL.—If the premises from which the shipment is made are located elsewhere than at the port of exportation, the beer shall be delivered either directly for customs inspection and supervision of lading, or to a carrier for transportation to the port of exportation and a copy of the export bill of lading shall be promptly forwarded to the Assistant Regional Commissioner of the region in which the claim for drawback is filed.

PAR. 21. Section 252.159 is amended by striking from the third sentence the words "brewer or his agent" and inserting in lieu thereof the word "exporter".

PAR. 22. Section 252.162 is amended by striking from the third sentence the word "one" and inserting in lieu thereof the words "the original".

PAR. 23. Section 252.165 is amended to read as follows:

§ 252.165 EVIDENCE OF LADING FOR USE ON VESSELS OR AIRCRAFT.—When beer has been laden on board a vessel or aircraft for use as ship's supplies or supplies for aircraft, there must be submitted promptly to the Assistant Regional Commissioner a statement of the master or other officer of the vessel or aircraft on which the articles were laden, having knowledge of the facts, showing that the beer has been laden and will be used as supplies on board the vessel or aircraft, and that no portion thereof has been or will be unladen in the United States or any of its territories or possessions: *Provided*, That such statement will not be required, in the case of any shipment, when the beer has been laden on vessels of war, or, in cases other than supplies on vessels employed in the fisheries, where the amount of tax on the beer does not exceed $200 and in such case certification by the customs officer of inspection and lading for use will be considered evidence of lading or use. Such statement shall be signed by the master or other officer having knowledge of the facts and immediately above the signature there will appear the following statement: "I declare under the penalties of perjury that this statement has been examined by me and to the best of my knowledge and belief is true and correct." In the case of vessels, employed in the fisheries, compliance with the provisions of § 252.3a is required.

Paragraphs 13 to 22, inclusive, of this Treasury Decision (identical to the amendments published in the Federal Register for March 27, 1956 (21 F. R. 1858)) are effective May 1, 1956. The purpose of paragraphs 1 to 12, inclusive, and paragraphs 23 of this Treasury Decision is to conform the applicable provisions of 26 CFR Part 252 with Treasury Decision 53935, which amended Customs regulations to define the type of vessels engaged in the fisheries which are entitled to withdraw distilled spirits, wines, and beer for use as supplies. It is necessary that the regulations in 26 CFR Part 252 conform with the amended Customs regulations as early as possible. Inasmuch as Treasury Decision 53935 became effective November 5, 1955, it is hereby found that it is impracticable and contrary to the public interest to issue paragraphs 1 to 12, inclusive, and paragraph 23 of this Treasury Decision subject to the effective date limitation of section 4(c) of the Administrative Procedure Act (60 Stat. 238; 5 U. S. C. 1003(c)). Accordingly, paragraphs 1 to 12, inclusive, and paragraph 23 of this Treasury Decision shall be effective on the date of publication in the Federal Register of this Treasury Decision.

(This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U. S. C. 7805).)

O. GORDON DELK,
Acting Commissioner of Internal Revenue.

RALPH KELLY,
Commissioner of Customs.

Approved June 4, 1956.

DAVID W. KENDALL,
Acting Secretary of the Treasury.

(Published in the Federal Register June 8, 1956)

SUBPART B.—RULINGS AND DECISIONS UNDER THE INTERNAL REVENUE CODE OF 1939

Rulings and decisions published in Part III, Subpart B, of the Internal Revenue Bulletin are based on the application of provisions of the Internal Revenue Code of 1939 and, unless otherwise noted therein, are published without consideration as to any application of the provisions of the Internal Revenue Code of 1954, the Federal Alcohol Administration Act, or other public laws.

CHAPTER 27.—OCCUPATIONAL TAXES

SUBCHAPTER A.—SPECIAL PROVISIONS

PART VII.—LIQUOR

SECTION 3250.—TAX

REGULATIONS 18, SECTION 192.240: Special tax.

Liability for special tax by a brewer during a fiscal year in which no beer was produced but untaxpaid beer was held on the brewery premises. See Rev. Rul. 56–238, page 711.

CHAPTER 28.—PROVISIONS COMMON TO MISCELLANEOUS TAXES

SUBCHAPTER B.—PROVISIONS OF SPECIAL APPLICATION TO THE VIRGIN ISLANDS AND PUERTO RICO

PART II.—PUERTO RICO

SECTION 3360.—SHIPMENTS TO THE UNITED STATES

For application of the so-called "Hurricane Tax Relief" Act, with respect to distilled spirits or wines lost by reason of the hurricanes of 1954, to distilled spirits or wines from Puerto Rico, see Rev. Rul. 56–99, page 812.

SUBPART C.—RULINGS AND DECISIONS UNDER THE FEDERAL ALCOHOL ADMINISTRATION ACT OR RELATED LAWS

Rulings and decisions published in Part III, Subpart C, of the Internal Revenue Bulletin are based on the application of provisions of the Federal Alcohol Administration Act.

FEDERAL ALCOHOL ADMINISTRATION ACT

SECTION 4.—PERMITS

27 CFR 1.1: Issuance, amendment, denial, suspension, revocation and duration of basic permits. — T. D. 6167 [1]

TITLE 27—INTOXICATING LIQUORS.—CHAPTER I, PART 1.—BASIC PERMIT REQUIREMENTS UNDER THE FEDERAL ALCOHOL ADMINSTRATION ACT

Technical amendment

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

In order to substitute references to the Internal Revenue Code of 1954 and regulations thereunder for the present references to the 1939 Code and regulations thereunder, the regulations relating to basic permit requirements under the Federal Alcohol Administration Act, 27 CFR part 1, are hereby amended as follows:

PARAGRAPH 1. The citation of the statutory authority for the regulation is amended to read as follows:

AUTHORITY: §§ 1.1 to 1.59 issued under 68A Stat. 917, 49 Stat. 977; 26 U. S. C. 7805; 27 U. S. C. 201 et seq.

PAR. 2. § 1.1 is amended by striking the clause "except that the provisions of Regulations 123, 'Rules of Practice in Permit Proceedings' (26 CFR (1939) part 200)," and substituting in lieu thereof "except that the provisions of 26 CFR (1954) Part 200, Rules of Practice in Permit Proceedings,".

PAR. 3. § 1.31, is amended by changing the reference "26 CFR Part 200," to "26 CFR (1954) part 200."

PAR. 4. §§ 1.35, 1.50, 1.51, 1.52, and 1.57 are amended by changing the reference "26 CFR (1939) part 200" to "26 CFR (1954) Part 200."

Because the only effect of this Treasury Decision is to substitute current references for regulations issued under the Internal Revenue Code,

[1] 21 F. R. 1859.

to conform the "authority" citation with such Code, and such changes are purely editorial in nature, it is hereby found unnecessary to issue this Treasury Decision with notice and public procedure thereon under Section 4(a) of the Administrative Procedure Act, approved June 11, 1946. This Treasury Decision shall be effective on the 30th day after publication in the Federal Register.

(This Treasury Decision is issued under the authority contained in 68A Stat. 917; 49 Stat. 977; 26 U. S. C. 7805; 27 U. S. C. 201 et seq.)

O. GORDON DELK,
Acting Commissioner of Internal Revenue.

Approved March 21, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary of the Treasury in Charge of Tax Policy.

(Published in the Federal Register March 27, 1956)

SECTION 5.—UNFAIR COMPETITION AND UNLAWFUL PRACTICE

Rev. Rul. 56–204

Subsections (a), (b), and (c) of section 5 of the Federal Alcohol Administration Act make it unlawful for a producer, importer, or wholesaler of alcoholic beverages to induce a retailer to purchase his products to the exclusion, in whole or in part, of similar products of other industry members, by means of the practices set forth therein. *Held*, such provisions do not prohibit retailers in alcoholic beverages from engaging in co-operative purchasing for the purpose of gaining advantages through co-operative buying.

FAA REGULATIONS NO. 5, SECTION 5.1: Definitions.

For suitable containers for packaging brandy on which age may properly be claimed, see Rev. Rul. 56–203, page 752.

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27 CFR 5.21: The standards of identity. T. D. 6174[1]

TITLE 27.—INTOXICATING LIQUORS—CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY [REGULATIONS NO. 5]

Part 5.—Labeling and Advertising of Distilled Spirits

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Notice of public hearing to be held in Washington, D. C., on December 1, 1955, with respect to certain proposals to amend Regulations

[1] 21 F. R. 3535.

No. 5, relating to Labeling and Advertising of Distilled Spirits, was published in the Federal Register on November 19, 1955 (20 F. R. 8574). Upon the conclusion of the said hearing and after consideration of all relevant material submitted by interested persons in connection therewith regarding the proposals, the following amendments to Regulations No. 5 (27 CFR, part 5) are hereby adopted:

PARAGRAPH 1. Section 21, class 4(a) (27 CFR 5.21(1)), by adding the following proviso at the end of the second sentence:

PROVIDED, That in the case of any fruit brandy, other than neutral brandy, pomace brandy, marc brandy or grappa brandy distilled from the fermented juice, mash, or wine of grapes, or the residue thereof, which has been aged for less than two years, the statement of the class (and type, if any) shall be preceded by the word "immature" appearing in the same size and kind of type and as a part thereof, e. g., "immature brandy" or "immature grape brandy".

PARAGRAPH 2. The proviso at the end of section 39(b)(1) (27 CFR 5.39(b)(1)) is amended to read as follows:

PROVIDED, That an appropriate statement with respect to age shall appear on the brand label in the case of brandy (other than immature brandies) not aged for a period of at least two years.

PARAGRAPH 3. Section 39(e)(5) (27 CFR 5.39(e)(5)) is amended by inserting immediately after the word "brandies" appearing in the proviso at the end of the first sentence thereof, the following: "(except immature brandies)".

PARAGRAPH 4. Section 64(c) (27 CFR 5.64(c)) is amended by inserting in the last sentence immediately after the word "brandy", the following: "(except immature brandies)".

This Treasury Decision shall become effective thirty days after publication in the Federal Register.

(This Treasury Decision is issued pursuant to and under the authority contained in 49 Stat. 981, as amended; 27 U. S. C. 205.)

HARRY J. TRAINOR,
Acting Commissioner.

Approved May 21, 1956.

DAN THROOP SMITH,
Special Assistant to the Secretary in Charge of Tax Policy.

(Published in the Federal Register May 25, 1956)

SECTION 5(b).—UNFAIR COMPETITION AND UNLAWFUL PRACTICES: TIED HOUSE

Rev. Rul. 56–205

Where a brewer sells to retailers beer dispensing units for use in connection with a particular style or type of container of the brewer for resale by the retailer to consumers, a violation of the Federal Alcohol Administration Act would ensue if such sales resulted in the proscribed inducement and exclusion.

Advice has been requested whether the sale of beer dispensing equipment by a brewer, for use in connection with a particular type of package put up by the brewer, to retailers and by the retailers to consumers is permissible.

A dispensing kit has been assembled which contains equipment necessary for use in removing beer from a particular type of beer container. The brewer would sell such dispensing kits, at cost, to retailers handling beer put up in the special type of containers. Such retailer would, in turn, sell the dispensing equipment to the consumer at the same price.

Section 5(b)(3) of the Federal Alcohol Administration Act, among other things, makes it unlawful for a brewer, either directly or indirectly or through an affiliate, to induce a retailer to purchase malt beverages from such brewer to the exclusion in whole or in part of malt beverages sold or offered for sale by others in interstate or foreign commerce, under the conditions outlined therein, by furnishing, giving, or selling to the retailer, any equipment, fixtures, supplies, or other thing of value, subject to certain exceptions prescribed in the Regulations relating to Inducements Furnished to Retailers.

The sale of these dispensing units to the retailer is not included within any of the exceptions to section 5(b)(3) of the Act. It is held that the sale thereof to retailers for resale at cost to consumers is likely to induce the retailers to purchase beer of the brewer to the exclusion of malt beverages sold by others. Accordingly, within the limits of Federal jurisdiction under section 5 of the Act, where such inducement and exclusion result from the practice, a violation of the statute would result.

Rev. Rul. 56–206

The furnishing by a wholesaler to a retailer, with each purchase of a particular brand or line of alcoholic beverages, of stamps redeemable for premiums, such stamps in turn to be given to the consumer upon the purchase of such beverage, falls within the coverage of section 5(b)(3) of the Federal Alcohol Administration Act.

Advice has been requested whether a wholesaler may give to a retailer, with each purchase of beer, stamps redeemable for premiums, the stamps in turn to be given to the customers of the retailer upon the purchase of that brand of beer.

A wholesaler would purchase and give to the retailer, with each purchase of beer by the retail licensee, commercial trading stamps redeemable for premiums. The retailer, in turn, would give the stamps to the consumer with the purchase of the particular brand of malt beverage. After the consumer had collected a certain number of the stamps, he could redeem them for appliances or other like premiums.

Section 5(b)(3) of the Federal Alcohol Administration Act makes it unlawful for a producer, importer, or wholesaler of distilled spirits, wine, or malt beverages, directly or indirectly, to induce a retailer to purchase his products to the complete or partial exclusion of competitive items by furnishing, giving, renting, lending, or selling to the retailer any equipment, fixture, signs, supplies, money, services, or other thing of value, subject to certain exceptions prescribed in the Regulations relating to Inducements Furnished to Retailers and not here relevant.

It is held that the stamps have a definite value in terms of equipment, such as appliance or the other things of value, and the procedure outlined falls within the coverage of section 5(b) of the Act. Accordingly, the giving of stamps redeemable for premiums by industry members to retailers and in turn by the retailers to consumers, in connection with the purchase of a particular brand of distilled spirits, wine, or beer, with the resulting inducement and exclusion proscribed by section 5(b)(3), would constitute a violation of the Act. With respect to the extent of the applicability of section 5(b) to transactions in malt beverages, see Revenue Ruling 54–390, C. B. 1954–2, 578.

SECTION 5(e).—UNFAIR COMPETITION AND UNLAWFUL PRACTICES: LABELING

Rev. Rul. 56–207

Revenue Ruling 54–324, C. B. 1954–2, 586, provides that a product classed as "flavored vodka" may not contain sugar in excess of 2½ percent and that such product containing excessive sugar must be designated as a liqueur. Since "flavored brandies," "flavored gins," and "flavored rums" normally contain sugar in excess of 2½ percent and since the consuming public has become aware that such products are sweet drinks, a 2½ percent restriction placed on the amount of sugar which may be contained in flavored vodka is contrary to the consumer conception of such liquors. Accordingly, it is held that a product may be designated as "flavored vodka" even though its sugar content exceeds 2½ percent. As is the case with flavored brandies, gins and rums, the product may not be bottled at less than 70 degrees of proof.

Revenue Ruling 54–324, *supra*, is hereby revoked.

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27 CFR 5.21: The standards of identity. Rev. Rul. 56–98

Section 21, class 1(a) of the Regulations relating to the Labeling and Advertising of Distilled Spirits, issued pursuant to the Federal Alcohol Administration Act, prescribes the standards of identity for vodka. It provides, in part, that if any flavoring material is added to the distillate it shall be designated "flavored vodka" and may be further classified with the name of the flavoring material used. *Held*, the use of sugar not exceeding two-tenths of one per cent and a trace amount of citric acid in the production of vodka would not materially affect the taste or change its basic character. Therefore, a product containing such ingredients within the limitations stated may be designated and labeled as vodka. However, if any flavoring ingredients are used, the product must be designated and labeled as "flavored vodka." The additon of any material to the vodka, including sugar or citric acid, will result in taxable rectification through compounding.

SUBPART D.—RULINGS AND DECISIONS UNDER OTHER PUBLIC LAWS INVOLVING THE VARIOUS ALCOHOL TAXES

Rulings and decisions published in Part III, Subpart D, of the Internal Revenue Bulletin are based on the application of provisions of other public laws dealing with alcohol tax matters, as stated therein.

HURRICANE TAX RELIEF ACT

PUBLIC LAW 363, 84TH CONGRESS

(Also Part III B, Section 3360.) Rev. Rul. 56–99

The Act of August 11, 1955, Public Law 363, 84th Congress, 69 Stat. 685, C. B. 1955–2, 643, provides relief in the form of refund or allowance of the internal revenue tax or internal revenue tax and customs duties paid on distilled spirits and wines produced in, or imported into, the United States and which have been lost, or rendered unmarketable, or condemned by a duly authorized health officer, by reason of the hurricanes of 1954. Section 3360 of the Internal Revenue Code of 1939 (section 7652 of the 1954 Code) provides, in part, that articles of merchandise of Puerto Rican manufacture coming into the United States and withdrawn for consumption or sale shall be subject to a tax equal to the internal revenue tax imposed in the United States upon the like articles of merchandise of domestic manufacture. *Held*, since the tax imposed by section 3360 of the 1939 Code is not an internal revenue tax to which the Act applies, but merely a tax equal in amount to the internal revenue tax, which amount is covered into the Puerto Rican Treasury, and since the distilled spirits and wines brought into the United States from Puerto Rico are neither produced in the United States nor considered to be imported into the country, the provisions of the Act of August 11, 1955, *supra*, are not applicable to such tax. Accordingly, no refund or credit can be allowed under that Act for taxes paid on such distilled spirits or wines lost, rendered unmarketable, or condemned by a duly authorized health officer, by reason of the hurricanes of 1954.

PART IV

LEGISLATION AND TREATIES

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PART IV

LEGISLATION AND TREATIES

SUBPART A.—TAX CONVENTIONS

UNITED STATES-BELGIUM INCOME TAX CONVENTION

T. D. 6160 [1]

TITLE 26—INTERNAL REVENUE, 1954.—CHAPTER I, SUBCHAPTER G, PART 504.—BELGIUM

General regulations under the income tax convention between the United States and Belgium, proclaimed by the President of the United States on September 23, 1953.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

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AUTHORITY: §§ 504.101 to 504.121, incl., issued under 68A Stat. 917; 26 U. S. C. 7805; and Art. XXI, income tax convention between the United States and Belgium, proclaimed by the President of the United States on Sept. 23, 1953.

On September 29, 1955, notice of proposed rulemaking regarding the general regulations under the income tax convention between the United States and Belgium [C. B. 1954–2,626], proclaimed by the

[1] 21 F. R. 235.

President of the United States on September 23, 1953, was published in the Federal Register (20 F. R. 7260). No comments regarding the regulations proposed were received during the 30-day period prescribed in such notice, and the regulations set forth below are hereby adopted:

§ 504.101 INTRODUCTORY.—The income tax convention between the United States and Belgium, signed October 28, 1948, as modified and supplemented by the supplementary convention between those Governments, signed September 9, 1952, hereinafter referred to as the convention, was proclaimed by the President of the United States on September 2, 1953, and is effective with respect to income derived in taxable years beginning on or after January 1, 1953. It provides, in part, as follows:

ARTICLE I

(1) The taxes which are the subject of the present Convention are:

(a) In the case of the United States: The Federal income taxes.

(b) In the case of Belgium: The income taxes, the national crisis tax, and the personal complementary tax, including all additions to these taxes.

(2) The present convention shall apply also to any other taxes of a substantially similar character imposed by either contracting State subsequently to the date of signature of the present convention or by the government of any territory to which the present convention is extended under Article XXII.

(3) In the event of appreciable changes in the fiscal laws of either of the contracting States the competent authorities of the contracting States will consult together.

ARTICLE II

(1) In the present convention, unless the context otherwise requires:

(a) The term "United States" means the United States of America, and when used in a geographical sense means the States, the Territories of Alaska and of Hawaii, and the District of Columbia.

(b) The term "Belgium" when used in a geographical sense means the Kingdom of Belgium in Europe.

(c) The term "United States enterprise" means an industrial or commercial enterprise or undertaking carried on in the United States by a citizen or resident of the United States or by a corporation or other juridical person created or organized in the United States or under the laws of the United States or of any State or Territory of the United States.

(d) The term "Belgian enterprise" means an industrial or commercial enterprise or undertaking carried on in Belgium by a citizen or resident of Belgium or by a corporation or other juridical person created or organized in Belgium or under the laws of Belgium.

(e) The terms "enterprise of one of the contracting States" and "enterprise of the other contracting State" mean a United States enterprise or a Belgian enterprise, as the context requires.

(f) The term "permanent establishment", when used with respect to an enterprise of one of the contracting States, means a branch, factory, mine, oil well, plantation, workshop, warehouse, installation, or other fixed place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of such enterprise or has control over a stock of merchandise from which he regularly fills orders on behalf of such enterprise. An enterprise of one of the contracting States shall not be deemed to have a permanent establishment in the other contracting State merely because it carries on business dealings in such other contracting State through a bona fide commission agent or broker acting in the ordinary course of his business as such. When a corporation of one contracting State has a subsidiary corporation which is a corporation created or organized in the other contracting State or which is engaged in trade or business in such other contracting State, such subsidiary corporation shall not, merely because of that fact, be deemed to be a permanent establishment of its parent corporation.

(g) The term "industrial and commercial profits" shall not include the following:

(i) Income from real property;

(ii) Income from mortgages, from public funds, securities (including mortgage bonds), loans, deposits, and current accounts;

(iii) Dividends and other income from shares in a corporation;

(iv) Rentals or royalties arising from leasing personal property or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property;

(v) Profit or loss from the sale or exchange of capital assets;

(vi) Compensation for labor or personal services.

Subject to the provisions of the present convention, the income referred to in subparagraphs (i) to (vi) shall be taxed separately or together with industrial and commercial profits in accordance with the laws of the contracting States.

(h) The term "competent authority" or "competent authorities" means, in the case of the United States, the Commissioner of Internal Revenue or his duly authorized representative; and in the case of Belgium, the Directeur General de l'Administration des Contributions Directes or his duly authorized representative; and, in the case of any territory to which the present convention is extended under Article XXII, the competent authority for the administration in such territory of the taxes to which the present convention applies.

(2) In the application of the provision of the present convention by either of the contracting States, any term which is not otherwise defined shall, unless the context otherwise requires, have the meaning which that term has under the laws of such contracting State relating to the taxes which are the subject of the present convention.

ARTICLE III

(1) An enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable to its permanent establishment in such other State.

(2) However, an enterprise of one of the contracting States is not subject to taxation by the other contracting State if it maintains in the latter State only an establishment which confines itself to the purchasing of merchandise for the purpose of supplying establishments which such enterprise maintains in the former State.

ARTICLE IV

(1) If an enterprise of one of the contracting States has a permanent establishment in the other contracting State, there shall be attributed to such permanent establishment the net industrial and commercial profit which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net profit will, in principle, be determined on the basis of the separate accounts pertaining to such establishment.

(2) The competent authority of the taxing State may, when necessary, in execution of paragraph (1) of this Article, rectify the accounts produced, notably to correct errors and omissions or to re-establish the costs, prices or remuneration entered in the books at the value which would prevail between independent persons. If

(a) an establishment does not produce an accounting showing its own operations, or

(b) the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or

(c) the rectifications provided for in this paragraph cannot be effected,

the competent authority of the taxing State may determine the net industrial and commercial profit by applying to the operations of the establishment such methods or formulae as may be fair and reasonable.

(3) To facilitate the determination of industrial and commercial profits which are allocable to the permanent establishment, the competent authorities of the

contracting States may consult together with a view to the adoption of uniform rules of allocation with respect to such profits.

(4) In the determination of the net industrial and commercial profits allocable to the permanent establishment there shall be allowed as deductions all expenses, wherever incurred, insofar as they are reasonably allocable to the permanent establishment, including executive and general administrative expenses so allocable.

ARTICLE V

When an enterprise of one of the contracting States, by reason of its participation in the management or financial structure of an enterprise of the other contracting State, makes with or imposes on the latter enterprise, in their financial or commercial relations, conditions different from those which would be made with an independent enterprise, any profits which, but for those conditions, would have accrued to one of the enterprises may be included in the taxable profits of that enterprise, subject to applicable measures of appeal.

ARTICLE VI

Income of whatever nature derived from real property shall be taxable only in the contracting Satte in which the real property is situated. This Article does not apply to income derived from mortgages or bonds secured by real property.

ARTICLE VII

(1) Income which an enterprise of one of the contracting States derives from the operation of ships or aircraft registered in that State shall be exempt from taxation in the other contracting State.

(2) The present convention shall not be deemed to affect the provisions of the exchange of notes between the United States and Belgium, dated January 28, 1936, providing for relief from double income taxation on shipping profits.

ARTICLE VIII

(1) The rate of United States tax on dividends derived from sources within the United States by a resident or corporation or other entity of Belgium not having a permanent establishment within the United States shall not exceed 15 percent.

(2) Belgium shall not impose on dividends derived from sources within Belgium by a resident or corporation or other entity of the United States not having a permanent establishment within Belgium any tax in the nature of a personal complementary tax or surtax thereon, or any tax similar to that withheld at the source on dividends under United States law in the case of nonresident aliens and foreign corporations.

ARTICLE VIIIA

The rate of tax imposed by each of the contracting States upon interest (on bonds, notes, debentures, or on any other form of indebtedness) derived from sources within such State by a resident or corporation or other entity of the other State not having a permanent establishment within the former State shall not exceed 15 percent.

ARTICLE IX

(1) Rentals or royalties from real property or in respect of the operation of mines, quarries or other natural resources shall be taxable only in the contracting State in which such property, mines, quarries or other natural resources are situated. A resident of Belgium, or a corporation or other juridical person created or organized in Belgium deriving such rentals or royalties from sources within the United States may elect for any taxable year to be subject to United States tax as if such resident, corporation or entity were engaged in trade or business within the United States through a permanent establishment therein in such taxable year.

(2) Royalties derived from within one of the contracting States by a resident or by a corporation or other entity of the other contracting State as consideration for the right to use copyrights, patents, secret processes and formulae, trade marks and other analogous rights shall be exempt from taxation in the former State, provided such resident, corporation or other entity does not have a perma-

nent establishment there. The term "royalties" as used in this paragraph shall be deemed to include rentals in respect of motion picture films.

ARTICLE X

(1) Wages, salaries and similar compensations, and pensions and annuities, paid by one of the contracting States or by the political subdivisions or territories thereof to citizens of that State residing in the other State (whether or not also citizens of such other State) shall be exempt from taxation in the latter State.

(2) Private pensions and annuities derived from within one of the contracting States and paid to individuals residing in the other contracting State shall be exempt from taxation in the former State.

(3) The term "pensions" as used in this Article means periodic payments made in consideration for services rendered or by way of compensation for injuries received.

(4) The term "annuities" as used in this Article means a stated sum payable periodically at stated times, under an obligation to make the payments in consideration of money paid.

ARTICLE XI

(1) A resident of the United States shall be exempt from Belgian tax upon compensation for labor or personal services performed within Belgium if he falls within either of the following classifications:

(a) He is temporarily present within Belgium for a period or periods not exceeding a total of ninety days during the calendar year and the compensation received for such labor or personal services does not exceed $3,000.00 in the aggregate, or its corresponding amount, except that the provisions of this subparagraph shall not apply to remuneration of "administrateurs", "commissaires", or "liquidateurs" of, or of other individuals exercising similar functions in corporations created or organized in Belgium;

(b) He is temporarily present within Belgium for a period or periods not exceeding a total of one hundred eighty-three days during the calendar year and his compensation is received for labor or personal services performed as a worker or employee of, or under contract with, a resident of, or a corporation or other juridical person created or organized in, the United States which carries the actual burden of the remuneration.

In such cases the United States reserves the right to tax such income.

(2) A resident of Belgium shall be exempt from United States tax upon compensation for labor or personal services performed within the United States if he falls within either of the following classifications:

(a) He is temporarily present within the United States for a period or periods not exceeding a total of ninety days during the taxable year and the compensation received for such labor or personal services does not exceed $3,000.00 in the aggregate, or its corresponding amount, except that the provisions of this subparagraph shall not apply to remuneration of officers and directors of corporations created or organized in the United States;

(b) He is temporarily present within the United States for a period or periods not exceeding a total of one hundred eighty-three days during the taxable year and his compensation is received for labor or personal services performed as a worker or employee of, or under contract with, a resident of, or a corporation or other juridical person created or organized in, Belgium which carries the actual burden of the remuneration.

In such cases Belgium reserves the right to tax such income.

(3) The provisions of this Article shall have no application to the income to which Article X relates.

ARTICLE XII

(1) Notwithstanding any provisions of the present convention (other than paragraph (1) of Article X) each of the two contracting States, in determining the income taxes, including all surtaxes, of its citizens or residents or corporations or other juridical persons, may include in the basis upon which such taxes are imposed all items of income taxable under its own revenue laws as though this convention had not come into effect.

(2) In accordance with the provisions of section 131 of the United States Internal Revenue Code as in effect on the day of the entry into force of the present convention, the United States agrees to allow as a deduction from the income taxes imposed by the United States the appropriate amount of taxes paid to Belgium, whether paid directly by the taxpayer or by withholding.

(3) In order to take into account the Federal income taxes collected in the United States, Belgium agrees, in conformity with the provisions of Belgian law relating to income taxes and the national crisis tax, as in effect on the day of the entry into force of the present convention, to reduce.

(a) to one-fifth, the professional tax and the national crisis tax which affect that part of the taxable income which is derived from sources within and taxed by the United States,

(b) to a maximum of 12 percent, the tax on income from personal and real property which has its source in the United States, and

(c) in derogation of the provisions of Belgian law, to one-fourth the personal complementary tax due by citizens or residents of the United States who are also residents of Belgium, in respect of income from sources within and taxed by the United States.

ARTICLE XIII

Professors or teachers, citizens of one of the contracting States, who, within the framework of agreements between the contracting States or between teaching establishments in the contracting States for the sending of professors and teachers, visit within the territory of the other contracting State to teach, for a maximum period of two years, in a university, college, school or other teaching establishment in the territory of such other contracting State, shall not be taxed by such other State with respect to the remuneration which they receive for such teaching.

ARTICLE XIV

Students or apprentices, citizens of one of the contracting States, residing in the other contracting State exclusively for purposes of study or for acquiring experience, shall not be taxable by the latter State in respect of remittances received by them from abroad for the purposes of their maintenance or studies.

ARTICLE XV

(1) The competent authorities of the contracting States shall exchange such information (being information available under the respective taxation laws of the contracting States) as is necessary for carrying out the provisions of the present convention or for the prevention of fraud or the administration of statutory provisions and regulations against legal avoidance in relation to the taxes which are the subject of the present convention.

(2) Documents and information contained therein, transmitted under the provisions of the present convention by one of the contracting States to the other contracting State shall not be published, revealed or disclosed to any person except to the extent permitted under the laws of the latter State with respect to similar documents or information.

ARTICLE XVI

The competent authority of each of the contracting States shall furnish, upon request by the competent authority of the other contracting State, particulars relative to the application in concrete cases of the taxes of the requesting State to which the present convention relates.

ARTICLE XVII

Each of the contracting States shall collect taxes, which are the subject of this convention, imposed by the other contracting State (as though such tax were a tax imposed by the former State) as will ensure that the exemption, or reduced rate of tax, as the case may be, granted under the present convention by such other State shall not be enjoyed by persons not entitled to such benefits.

ARTICLE XVIII

(1) In no case shall the provisions of Articles XV, XVI, and XVII be construed so as to impose upon either of the contracting States the obligation

(a) to carry out administrative measures at variance with the regulations and practice of either contracting State, or

(b) to supply information or particulars which are not procurable under its own legislation or that of the State making the application.

(2) The State to which application is made for information or assistance shall comply as soon as possible with the request addressed to it. Nevertheless, such State may refuse to comply with the request for reasons of public policy or if compliance would involve violation of a business, industrial or trade secret. In such case it shall inform, as soon as possible, the State making the application.

ARTICLE XIX

Where a taxpayer shows proof that the action of the tax administrations of the contracting States has resulted or will result in double taxation in his case in respect of any of the taxes to which the present convention relates, he shall be entitled (within a period of two years from the date of the notification of the tax which has been last asserted or proposed, or of the payment of the tax if such payment has been made prior to notification) to lodge a claim with the State of which he is a citizen, or, if he is not a citizen of either of the contracting States, with the State of which he is a resident, or, if the taxpayer is a corporation or other juridical person, with the State in which it is created or organized. Should the claim be upheld, the competent authorities of the two contracting States shall come to an agreement with a view to equitable avoidance of the double taxation in question.

ARTICLE XX

(1) The provisions of the present convention shall not be construed to restrict in any manner any exemption, deduction, credit or other allowance accorded by the laws of one of the contracting States in the determination of the tax imposed by such State.

(2) Should any difficulty or doubt arise as to the interpretation or application of the present convention, the competent authorities of the contracting States shall settle the question by mutual agreement.

(3) Citizens or corporations or other juridical persons of one of the contracting States within the other contracting State shall not be subjected, as regards the taxes referred to in the present convention, to the payment of higher taxes than are imposed upon the citizens or corporations or other juridical persons of such other contracting State.

ARTICLE XXI

The competent authorities of the two contracting States may (in the case of the United States, with the approval of the Secretary of the Treasury, and in the case of Belgium, with the approval of the Minister of Finance) prescribe regulations necessary to carry out the provisions of the present convention. With respect to the provisions of the present convention relating to exchange of information and mutual assistance in the collection of taxes, such authorities may, by common agreement, prescribe rules concerning matters of procedure, forms of application and replies thereto, conversion of currency, disposition of amounts collected, minimum amounts subject to collection, and related matters.

ARTICLE XXII

(1) Either of the contracting States may, at the time of exchange of instruments of ratification or thereafter while the present convention continues in force, by a written notification of extension given to the other contracting State through diplomatic channels, declare its desire that the operation of the present convention, either in whole or as to such provisions thereof as may be deemed to have special application, shall extend to any of its colonies or overseas territories which imposes taxes substantially similar in character to those which are the subject of the present convention.

(2) In the event that a notification is given by one of the contracting States in accordance with paragraph (1) of this Article, the present convention, or such provisions thereof as may be specified in the notification, shall apply to any territory named in such notification on and after the first day of January following the date of a written communication through diplomatic channels addressed to such contracting State by the other contracting State, after such action by the

latter State as may be necessary in accordance with its own procedures, stating that such notification is accepted in respect of such territory. In the absence of such acceptance, none of the provisions of the present convention shall apply to such territory.

(3) At any time after the expiration of one year from the effective date of an extension made by virtue of paragraphs (1) and (2) of this Article, either of the contracting States may, by a written notice of termination given to the other contracting State through diplomatic channels, terminate the application of the present convention to any territory to which the convention, or any of its provisions, has been extended. In that case, the present convention, or the provisions thereof specified in the notice of termination, shall cease to be applicable to any of the territories named in such notice of termination on and after the first day of January following the expiration of a period of six months after the date of such notice; provided, however, that this shall not affect the continued application of the convention, or any of the provisions thereof, to the United States, to Belgium, or to any territory (not named in the notice of termination) to which the convention, or such provision thereof, applies.

(4) For the application of the present convention to any territory to which it is extended by the United States or by Belgium, references to "the United States" or to "Belgium" or to one or the other contracting State, as the case may be, shall be construed to refer to such territory.

(5) For the purposes of the present convention, the Belgian Congo shall be considered to be a Belgian territory to which the provisions of this Article shall apply.

ARTICLE XXIII

(1) The present convention shall be ratified and the instruments of ratification shall be exchanged at Brussels as soon as possible.

(2) The present convention shall become effective with respect to income derived in taxable years beginning on or after the first day of January of the calendar year in which the exchange of the instruments of ratification takes place, except that if such exchange takes place after the thirtieth day of September of such calendar year, Article VIII and VIIIA and Article IX(2) shall become effective only with respect to payments made after the thirty-first day of December of such calendar year. It shall continue effective for a period of five years beginning with the first day of January of the calendar year in which such exchange takes place and indefinitely after that period, but may be terminated by either of the contracting States at the end of the five-year period or at any time hereafter, provided that at least six months' prior notice of termination has been given, the termination to become effective on the first day of January following the expiration of the six-month period.

PROCLAMATION BY THE PRESIDENT OF THE UNITED STATES DATED SEPTEMBER 23, 1953

* * * * * * *

And whereas the Senate of the United States of America by their resolution of July 9, 1953, two-thirds of the Senators present concurring therein, did advise and consent to the ratification of the two conventions aforesaid;

And whereas the two conventions aforesaid were duly ratified by the President of the United States of America on July 23, 1953, in pursuance of the aforesaid advice and consent of the Senate, and the two conventions aforesaid were duly ratified on the part of Belgium;

And whereas the respective instruments of ratification of the two conventions aforesaid were duly exchanged at Brussels on September 9, 1953, and a protocol of exchange was signed at that place and on that date by the respective Plenipotentiaries of the United States of America and Belgium;

And whereas it is provided in Article XXIII of the aforesaid convention of October 28, 1948, as amended by Article I(g) of the aforesaid convention of September 9, 1952, that the convention shall become effective with respect to income derived in taxable years beginning on or after the first day of January of the calendar year in which the exchange of the instruments of ratification takes place, provided such exchange takes place on or before the thirtieth day of September of such calendar year;

And whereas it is provided in Article II of the aforesaid convention of September 9, 1952, that the supplementary convention shall be regarded as an integral part of the convention of October 28, 1948, and shall become effective

and continue effective in accordance with Article XXIII of that convention as amended by Article I(g) of the supplementary convention;

Now, therefore, be it known that I, Dwight D. Eisenhower, President of the United States of America, do hereby proclaim and make public the aforesaid convention of October 28, 1948, and the aforesaid convention of September 9, 1952, to the end that the s ame and every article and clause thereof may be observed and fulfilled with good faith by the United States of America, and by the citizens of the United States of America, and all other persons subject to the jurisdiction thereof, the said conventions being deemed to be effective with respect to income derived in taxable years beginning on or after January 1, 1953.

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§ 504.102 APPLICABLE PROVISIONS OF LAW.—(a) *In general.*—The Internal Revenue Code of 1954 provides, in part, as follows:

SUBTITLE A.—INCOME TAXES

* * * * * * *

SEC. 894. INCOME EXEMPT UNDER TREATY.

Income of any kind, to the extent required by any treaty obligation of the United State, shall not be included in gross income and shall be exempt from taxation under this subtitle.

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SUBTITLE F.—PROCEDURE AND ADMINISTRATION

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SEC. 7805. RULES AND REGULATIONS.

(a) AUTHORIZATION.—Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

(b) RETROACTIVITY OF REGULATIONS OR RULINGS.—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

* * * * * * *

(b) *Internal Revenue Code of 1939.*—Any reference in this Treasury Decision to any provision of the Internal Revenue Code of 1954 shall, where applicable, be deemed also to refer to the corresponding provision of the Internal Revenue Code of 1939.

(c) *Effective date of regulations.*—Pursuant to section 7805 of the Internal Revenue Code of 1954, Article XXI of the convention, and other provisions of the internal revenue laws of the United States, this Treasury Decision, which is designated as 26 CFR 504.101 through 504.121, is hereby prescribed effective with respect to income derived in taxable years beginning on or after January 1, 1953. All regulations inconsistent herewith are modified accordingly.

§ 504.103 SCOPE OF THE CONVENTION.—(a) *Purposes of the convention.*—The primary purposes of the convention, to be accomplished on a reciprocal basis, are to avoid double taxation upon certain items of income derived from sources within one country by citizens, residents, or corporations or other entities of the other country, and to provide for administrative cooperation between the competent tax authorities of the two countries looking to the avoidance of double taxation and the prevention of fiscal evasion.

(b) *Exemption from United States tax of income from sources within the United States.*—The following items of income from

sources within the United States are exempt from United States tax for taxable years beginning on or after January 1, 1953, subject to the respective articles of the convention:

(1) Industrial and commercial profits of a Belgian enterprise having no permanent establishment in the United States (Article III);

(2) Income derived by a Belgian enterprise from the operation of ships or aircraft registered in Belgium (Article VII);

(3) Patent and copyright royalties, and other like amounts, including motion picture film rentals, derived by a nonresident alien who is a resident of Belgium, or by a Belgian corporation or other entity, if such alien, corporation, or other entity has no permanent establishment in the Unlted States. (Article IX);

(4) Private pensions and annuities paid to a nonresident alien individual who is a resident of Belgium Article X);

(5) Compensation, subject to certain limitations, for personal services performed in the United States by a nonresident alien individual who is a resident of Belgium (Article XI); and

(6) Remuneration derived from certain teaching in the United States by a nonresident alien professor or teacher who is a citizen of Belgium (Article XIII).

(c) *Reduced rates of United States tax on certain dividends and interest.*—Dividends and interest derived from sources within the United States by a nonresident alien who is a resident of Belgium, or by a Belgian corporation or other entity, are subject to United States tax at reduced rates if such alien, corporation or other entity has no permanent establishment in the United States (Articles VIII and VIIIA).

(d) *Exemption from United States tax of certain amounts paid by Belgium.*—Compensation, pensions, and annuities paid by Belgium to a Belgian citizen (whether or not he is also a citizen of the United States) who is residing in the United States are exempt from United States tax (Article X).

(e) *Exemption from United States tax of certain amounts received by students or apprentices.*—Remittances received from abroad for the purpose of maintenance or studies by a nonresident alien student or apprentice who is a citizen of Belgium temporarily present in the United States under specified circumstances are exempt from United States tax, Article XIV).

(f) *Liability to United States tax of United States citizens and residents.*—Any citizen of Belgium who is a resident of the United States is liable to United States tax as though the convention had not come into effect; however, such individual is entitled to the benefits of Article X(1), relating to government wages, salaries, pensions, and annuities, Article XII(2), relating to credit against United States tax for Belgian tax, and Article XX. Moreover, a citizen of the United States, even though resident in Belgium, or a domestic corporation, even though engaged in trade or business in Belgium through a permanent establishment situated therein, is liable to United States tax as though the convention had not come into effect; however such individual or domestic corporation is entitled to the benefits of Article XII(2), relating to credit against United States tax for Belgian tax,

and such individual is entitled to the benefits of Article X(1) insofar as it relates to government wages, salaries, pensions, and annuities in the case of dual citizenship.

(g) *Liability to United States tax of certain nonresident aliens and foreign corporations.*—Except as otherwise expressly provided by the convention, the United States tax liability of a nonresident alien who is a resident of Belgium, or of a Belgian corporation or other entity, is to be determined in accordance with the provisions of the Internal Revenue Code of 1954 relating to nonresident alien individuals and foreign corporations.

§ 504.104 DEFINITIONS.—(a) *In general.*—Any term defined in the convention or this Treasury Decision shall have the meaning so assigned to it. Unless the context requires otherwise, any term not so defined shall have the meaning which it has under the internal revenue laws of the United States.

(b) *Specific terms.*—As used in this Treasury Decision—

(1) *United States tax.*—The term "United States tax" means the Federal income taxes, including surtaxes, and any other income tax of a substantially similar character imposed by the United States after October 28, 1948.

(2) *Belgian tax.*—The term "Belgian tax" means the income taxes, the national crisis tax, and the personal complementary tax of Belgium, including all additions to these taxes, and any other tax of a substantially similar character imposed by Belgian after October 28, 1948.

(3) *United States.*—The term "United States" means the United States of America, and when used in a geographical sense, means the States, the Territories of Alaska and Hawaii, and the District of Columbia.

(4) *Belgium.*—The term "Belgium" when used in a geographical sense means the Kingdom of Belgium in Europe.

(5) *Enterprise.*—The term "enterprise" means any commercial or industrial enterprise or undertaking carried on by any person (e. g., an individual, a partnership, or a corporation). It includes such activities as manufacturing, merchandising, mining, processing, banking, and insuring. It does not include the rendition of personal services. Hence, a nonresident alien who is a citizen or resident of Belgium and who performs personal services is not, merely by reason of those services, engaged in a Belgian enterprise within the meaning of the convention, and his liability to United States tax is not determined under Article III of the convention, if he has not otherwise carried on a Belgian enterprise.

(6) *United States enterprise.*—The term "United States enterprise" means an enterprise carried on in the United States by a citizen or resident of the United States or by a corporation or other juridical person created or organized in the United States or under the laws of the United States or of any State or Territory of the United States.

(7) *Belgian enterprise.*—The term "Belgian enterprise" means an enterprise carried on in Belgium by a nonresident alien who is a citizen or resident of Belgium or by a corporation or other jurid-

ical person created or organized in Belgium or under the laws of Belgium.

(8) *Permanent establishment.*—(i) *Fixed place of business.*—The term "permanent establishment", when used with respect to an enterprise, means a branch, factory, mine, oil well, plantation, workshop, warehouse, installation, or other fixed place of business. It implies the active conduct of a business enterprise. The mere ownership, for example, of timberlands or a warehouse in the United States by a Belgian enterprise does not mean that such enterprise, in the absence of any business activity therein, has a permanent establishment in the United States.

(ii) *Agency.*—A Belgian enterprise which has an agency in the United States does not thereby have a permanent establishment in the United States, unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of the enterprise, or unless he has control over a stock of merchandise from which he regularly fills orders on its behalf. If the enterprise has an agent in the United States who has power to contract on its behalf, but only at fixed prices and under conditions determined by the enterprise, it does not thereby necessarily have a permanent establishment in the United States. The mere fact that an agent of a Belgian enterprise—assuming he has no general authority to negotiate and conclude contracts on behalf of his principal—maintains samples, or occasionally fills orders from incidental stocks of goods maintained, in the United States does not of itself mean that the enterprise has a permanent establishment in the United States. The mere fact that salesmen, employees of a Belgian enterprise, promote the sale of their employer's products in the United States or that a Belgian enterprise transacts business in the United States by means of mail order activities does not mean that the enterprise has a permanent establishment in the United States. A Belgian enterprise shall not be deemed to have a permanent establishment in the United States merely because it carries on business dealings in the United States through a bona fide commission agent or broker acting in the ordinary course of his business as such.

(iii) *Subsidiary corporation.*—The fact that a Belgian corporation has a domestic subsidiary corporation, or a foreign subsidiary corporation which is engaged in trade or business in the United States through a permanent establishment situated therein, does not of itself constitute either subsidiary corporation a United States permanent establishment of the Belgian parent corporation.

(9) *Industrial and commercial profits.*—The term "industrial and commercial profits" means profits arising from industrial, commercial, mercantile, manufacturing, and like activities of an enterprise. It does not include the following:

(i) Income from real property;

(ii) Income from mortgages, public funds, securities (including mortgage bonds), loans, deposits, and current accounts;

(iii) Dividends and other income from shares in a corporation;

(iv) Rentals or royalties arising from leasing personal property or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, patents, copyrights, secret processes and formulae, good will, trade marks, trade brands, franchises, and other like property;

(v) Profit or loss from the sale or exchange of capital assets; and

(vi) Compensation for labor or personal services.

(10) *Commissioner.*—The term "Commissioner" means the Commissioner of Internal Revenue or his duly authorized representative.

(11) *Directeur General.*—The term "Directeur General" means the Directeur General de l'Administration des Contributions Directes of Belgium or his duly authorized representative.

§ 504.105 INDUSTRIAL AND COMMERCIAL PROFITS.—(a) *In general.*—(1) Article III(1) of the convention adopts the principle that an enterprise of one of the contracting States shall not be taxable by the other contracting State in respect of its industrial and commercial profits unless it is engaged in trade or business in the latter State through a permanent establishment situated therein. Accordingly, a Belgian enterprise is subject to United States tax upon its industrial and commercial profits, to the extent of such profits from sources within the United States, only if it is engaged in trade or business in the United States at some time during the taxable year through a permanent establishment situated therein.

(2) From the standpoint of the United States tax, Article III(1) has application only to a Belgian enterprise and its industrial and commercial profits from sources within the United States. Thus, a nonresident alien individual who is a citizen or resident of Belgium, or a Belgian corporation, or other entity, carrying on an enterprise which is not a Belgian enterprise is subject to tax on such profits pursuant to secton 871(c) or section 882(a), Internal Revenue Code of 1954, if such alien, corporation, or other entity was engaged in trade or business in the United States at any time during the taxable year, even though it did not have a permanent establishment therein at any time within such year.

(b) *No United States permanent establishment.*—A Belgian enterprise is not subject to United States tax with respect to its industrial and commercial profits from sources within the United States, nor are such profits includible in gross income, if the enterprise at no time during the taxable year in which such profits were derived was engaged in trade or business in the United States through a permanent establishment situated therein. For example, if during the taxable year, an enterprise carried on in Belgium by a nonresident alien individual who is a citizen or resident of Belgium, or by a Belgian corporation, were to sell merchandise, such as textiles, chemicals, or electrical products, in the United States through a bona fide commission agent or broker in the United States acting in the ordinary course of his business as such agent or broker, the profits arising from the sale would not be includible in gross income and would be exempt from United States tax under Article III(1) of the convention. Similarly, if during the taxable year, the enterprise were to secure orders in the United States

for such merchandise through its sales agents whose sole function in the United States is sales promotion, the orders being transmitted to Belgium for acceptance, then the profits arising from such sales would not be includible in gross income and would be exempt from United States tax.

(c) *United States permanent establishment.*—(1) *In general.*—A Belgian enterprise is subject to United States tax with respect to its industrial and commercial profits from sources within the United States to the same extent as are nonresident aliens or foreign corporations, which are subject to tax pursuant to section 871(c) or section 882(a), Internal Revenue Code of 1954, if such enterprise at any time during the taxable year in which such profits were derived was engaged in trade or business in the United States through a permanent establishment situated therein. If it was so engaged, it is subject to United States tax upon its entire income from sources within the United States, except to the extent otherwise exempt from United States tax.

(2) *Allocation of profits thereto.*—In the determination of the income taxable to such enterprise for purposes of the United States tax, all industrial and commercial profits from sources within the United States shall be deemed to be allocable to the permanent establishment in the United States. Hence, if a Belgian enterprise which had a permanent establishment in the United States at some time during the taxable year were to sell in the United States, through a bona fide commission agent therein acting in the ordinary course of his business as such, merchandise which was produced in Belgium, the profits arising from such sale would be allocable to the permanent establishment to the extent they were derived from sources within the United States, even though the sale was made independently of the permanent establishment.

(3) *Determination of profits thereof.*—The industrial and commercial profits allocable to the permanent establishment in the United States shall be its net industrial and commercial profits determined as if the establishment were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net profits will, in principle, be determined on the basis of the separate accounts pertaining to such establishment. In arriving at such net profits, there shall be allowed as deductions all expenses, wherever incurred, insofar as they are reasonably allocable to the permanent establishment, including executive and general administrative expenses so allocable. When necessary in making this determination, the Commissioner may rectify the accounts produced, notably to correct errors and omissions or to re-establish the costs, prices or remunerations entered in the books at the value which would prevail between independent persons. In the event that—

(i) An establishment does not produce an accounting showing its own operations, or

(ii) The accounting produced does not correspond to the normal usages of the trade in the United States, or

(iii) The rectifications so provided cannot be effected,

the Commissioner may determine the net industrial and commercial profits by applying to the operations of the establishment such methods or formulae as may be fair and reasonable.

(d) *United States establishment for purchase of merchandise.*—Article III(2) of the convention adopts the principle that an enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits if it maintains in the latter State only an establishment which confines itself to the purchasing of merchandise for the purpose of supplying establishments which such enterprise maintains in the former State. Accordingly, a Belgian enterprise is not subject to United States tax upon such profits if it maintains in the United States only an establishment confining itself to the purchasing of merchandise for such Belgian enterprise. In the event that such establishment does not so confine itself or in the event that such Belgian enterprise also maintains in the United States any other kind of establishment, then the exemption accorded by Article III(2) shall not apply.

§ 504.106 Control of a United States Enterprise by a Belgian Enterprise.—Article V of the convention provides, in effect, that if a Belgian enterprise by reason of its control of a United States enterprise imposes on the latter enterprise conditions different from those which would result from normal business relations between independent enterprises, the accounts between the enterprises shall be adjusted in order to ascertain the true taxable income of each enterprise. The purpose is to place the controlled United States enterprise on a tax parity with an uncontrolled United States enterprise by determining, according to the standard of an uncontrolled enterprise, the true taxable income from the property and business of the controlled enterprise. The basic objective of the article is that if the accounting records do not truly reflect the taxable income from the property and business of the United States enterprise, the Commissioner shall intervene, and, by making such distributions, apportionments or allocations as he may deem necessary of gross income, deductions, credits or allowances, or of any item or element affecting taxable income, between the United States enterprise and the Belgian enterprise by which it is controlled or directed, shall determine the true taxable income of the United States enterprise. The provisions of section 482 of the Internal Revenue Code of 1954, and the regulations thereunder, shall, insofar as applicable, be followed in the determination of the taxable income of the United States enterprise.

§ 504.107 Income From Operation of Ships or Aircraft.—Under Article VII of the convention, so much of the income from sources within the United States of a Belgian enterprise as consists of earnings derived from the operation of ships or aircraft registered in Belgium shall not be included in gross income and shall be exempt from United States tax, even though at some time during the taxable year the enterprise was engaged in trade or business in the United States through a permanent establishment situated therein. The provisions of Article VII shall not be deemed to affect the provisions for relief from double income taxation on shipping profits contained in the exchange of notes between the United States and Belgium, dated January 28, 1936 (Executive Agreement Series, No. 87; 49 Stat. 3871).

§ 504.108 Dividends and Interest.—(a) *In general.*—(1) The rate of United States tax imposed by the Internal Revenue Code of

1954 upon dividends and upon interest on bonds, securities, notes, debentures, or any other form of indebtedness (including interest on obligations of the United States and its instrumentalities and on mortgages and bonds secured by real property), derived from sources within the United States by a nonresident alien individual who is a resident of Belgium or by a Belgian corporation or other entity, shall not exceed 15 percent under the provisions of Articles VIII and VIIIA of the convention, if such alien, corporation, or other entity at no time during the taxable year in which such dividends or interest was derived had a permanent establishment within the United States.

(2) If, for example, a nonresident alien individual who is a resident of Belgium performs personal services within the United States during the taxable year, but has at no time during such year a permanent establishment within the United States, he is entitled to the reduced rate of tax with respect to dividends derived in that year from United States sources, as provided in Article VIII of the convention, even though under the provisions of section 871(c) of the Internal Revenue Code of 1954 he has engaged in trade or business within the United States during such year by reason of his having performed personal services therein.

§ 504.109 Real Property Income and Natural Resource Royalties.—(a) *In general.*—Income of whatever nature derived by a nonresident alien who is a resident of Belgium, or by a Belgian corporation or other entity, from real property situated in the United States, including gains derived from the sale or exchange of such property, rentals and royalties from such property, and rentals and royalties in respect of the operation of mines, quarries, timber, or other natural resources situated in the United States, is not exempt from United States tax by the convention. Such items of income are subject to taxation under the provisions of the Internal Revenue Code of 1954 generally applicable to the taxation of nonresident alien individuals and foreign corporations. See Articles VI and IX(1) of the convention. Interest derived from mortgages and bonds secured by real property does not constitute income from real property for the purpose of this section but is subject to the provisions applicable to interest generally. See § 504.108.

(b) *Net basis.*—(1) *In general.*—Notwithstanding the provisions of paragraph (a) of this section, a nonresident alien who is a resident of Belgium, or a Belgian corporation or other entity, who during the taxable year derives from sources within the United States any rentals or royalties from real property situated in the United States or in respect of the operation of mines, quarries, timber, or other natural resources situated therein may elect for such taxable year to be subject to United States tax on a net basis as though such alien, corporation, or other entity were engaged in trade or business in the United States during such year through a permanent establishment situated therein. See Article IX(1) of the convention.

(2) *Manner of election.*—The nonresident alien individual who is a resident of Belgium shall signify his election to be subject to tax on such a basis by filing Form 1040B clearly marked at the top of the first page thereof as follows: "Return of Resident of Belgium Electing to File on a Net Basis Pursuant to Article IX of Belgian Income Tax Convention." The Belgian corporation shall signify its election to

be subject to tax on such a basis by filing Form 1120 clearly marked at the top of the first page thereof as follows: "Return of Belgian Corporation Electing to File on a Net Basis Pursuant to Article IX of Belgian Income Tax Convention." An election so signified shall be irrevocable for the taxable year for which such election is made. All income from sources within the United States, including gains from the sale or exchange of capital assets or of other property, shall be disclosed on the return so filed. See sections 871 and 882 of the Internal Revenue Code of 1954 and the regulations thereunder.

§ 504.110 PATENT AND COPYRIGHT ROYALTIES AND FILM RENTALS.—Royalties representing consideration for the right to use copyrights, patents, secret processes and formulae, trade marks, and other analogous rights, including rentals in respect of motion picture films, which are derived from sources within the United States by a nonresident alien individual who is a resident of Belgium, or by a Belgian corporation or other entity, are exempt from United States tax under the provisions of Article IX(2) of the convention if such alien, corporation, or other entity at no time during the taxable year in which such items of income were derived had a permanent establishment in the United States.

§ 504.111 GOVERNMENT WAGES, SALARIES, PENSIONS, AND ANNUITIES.—(a) *In general.*—Under Article X(1) of the convention, amounts constituting wages, salaries, or similar compensation, or pensions or annuities, paid by Belgium or its political subdivisions or territories to individuals residing in the United States who are Belgan citizens (whether or not also citizens of the United States) are not includible in gross income and are exempt from United States tax.

(b) *Definitions.*—As used in this section, the term "pensions" means periodic payments made in consideration for services rendered or by way of compensation for injuries received, and the term "annuities" means a stated sum payable periodically at stated times under an obligation to make the payments in consideration of money paid.

(c) *Other provisions.*—The exclusion from gross income and the exemption from United States tax provided by this section shall not be denied despite the provisions of Article XII(1) of the convention. See § 504.116. As to the taxation generally of compensation of alien employees of foreign governments and the consequences of executing and filing the waiver provided for in section 247(b) of the Immigration and Nationality Act, see section 893 of the Internal Revenue Code of 1954 and the regulations thereunder.

§ 504.112 PRIVATE PENSIONS AND ANNUITIES.—(a) *In general.*—In accordance with Article X(2) of the convention, private pensions and annuities derived from sources within the United States and paid to a nonresident alien individual who is a resident of Belgium shall not be includible in gross income and shall be exempt from United States tax, even though at some time during the taxable year in which such items of income were derived the individual was engaged in trade or business in the United States through a permanent establishment situated therein.

(b) *Definitions.*—As used in this section, the term "pensions" means periodic payments made in consideration for services rendered or by way of compensation for injuries received, and the term "annuities"

means a stated sum payable periodically at stated times under an obligation to make the payments in consideration of money paid. Neither term includes retired pay or pensions paid by the United States or by any State or Territory of the United States.

§ 504.113 Compensation for Labor or Personal Services—(a) *Exemption from United States tax.*—Under Article XI (2) of the convention, compensation received by a nonresident alien individual who is a resident of Belgium for labor or personal services performed in the United States shall not be includible in gross income and shall be exempt from United States tax in either of the following situations:

(1) *Belgian employers.*—Where such individual is temporarily present in the United States for a period or periods not exceeding in the aggregate a total of 183 days during a taxable year beginning on or after January 1, 1953, and where the compensation, regardless of amount, received by him (irrespective of when received, if received in taxable years beginning on or after January 1, 1953) for such labor or personal services performed in the United States during such year, was earned as a worker for or an employee of, or under contract with, a nonresident alien who is a resident of Belgium, or a Belgian corporation or other entity. For the exemption from tax provided by this subparagraph to apply, the Belgian resident, or the Belgian corporation or other entity, for whom the labor or personal services are performed must actually bear the expense of such compensation and must not be reimbursed therefor by any other person. For the purpose of the exemption, it is immaterial that the Belgian resident, corporation or other entity for whom the labor or personal services are performed is engaged in trade or business in the United States.

(2) *Other employers.*—Where such individual is temporarily present in the United States for a period or periods not exceeding in the aggregate a total of 90 days during a taxable year beginning on or after January 1, 1953, and where the compensation received by him (irrespective of when received, if received in taxable years beginning on or after January 1, 1953) for such labor or personal services performed in the United States during such year does not exceed $3,000 in the aggregate or the equivalent thereof. The provisions of this subparagraph do not apply to remuneration of officers and directors of domestic corporations for services performed as such officers and directors. Application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). B, a nonresident alien individual who is a resident of Belgium, performs personal services in the United States during the taxable year as an employee of a domestic corporation. His compensation for these services is $5,000. None of this compensation is exempt from United States tax even though B is temporarily present in the United States during such year for a period or periods not exceeding a total of 90 days, since the aggregate compensation received is in excess of $3,000.

Example (2). C, a nonresident alien individual who is a resident of Belgium, is temporarily present in the United

States for a period of 60 days during the taxable year. While in the United States he performs personal services for X Company (a domestic corporation) as an officer thereof and for Y Company (a domestic corporation) as an employee thereof. For these services X Company pays him $1,000 and Y Company pays him $2,900. In determining, for the purposes of this subparagraph whether C received compensation for personal services in excess of $3,000, the amount received by him as an officer of X Company is not taken into consideration. Therefore, since the compensation received by C for personal services which he performs in the United States during the taxable year is not in excess of $3,000 and he is temporarily present in the United States for a period not exceeding 90 days, the $2,900 received from Y Company is exempt from United States tax and is not includible in C's gross income. The $1,000 received from X Company is includible in C's gross income.

(b) *Miscellaneous applicable rules.*—For purposes of this section, the term "compensation for labor or personal services" shall include, but shall not be limited to, the compensation, profits, emoluments, or other remuneration of public entertainers, such as stage, motion picture, television, or radio artists, musicians, and athletes. For the allocation or segregation as between sources within, and sources without, the United States in the case of compensation for labor or personal services, see sections 861 through 864 of the Internal Revenue Code of 1954, and the regulations thereunder.

(c) *Certain compensation paid by Belgium.*—The provisions of this section have no application to the income to which Article X relates.

§ 504.114 Visiting Professors or Teachers.—(a) *In general.*—Pursuant to Article XIII of the convention, a professor or teacher, a nonresident alien who is a citizen of Belgium, who temporarily visits the United States for the purpose of teaching for a period not exceeding two years at any university, college, school, or other teaching establishment situated within the United States shall, for a period not exceeding two years from the date of his initial arrival in the United States, be exempt from United States tax with respect to his remuneration derived in taxable years beginning on or after January 1, 1953, for such teaching during such period not in excess of two years. The provisions of this paragraph are applicable only to the remuneration of professors or teachers visiting the United States pursuant to an agreement for the exchange of professors and teachers between the United States and Belgium or between a teaching establishment situated in the United States and a teaching establishment situated in Belgium.

(b) *Nonresidence presumed.*—An individual who otherwise qualifies for the exemption from United States tax granted by Article XIII shall, for a period of not more than two years immediately succeeding the date of his arrival within the United States for the purpose of such teaching, be deemed to have the tax status of a nonresident alien in the absence of proof of his intention to remain indefinitely in the United States. See section 871 of the Internal Revenue Code of 1954 and the regulations thereunder.

§ 504.115 STUDENTS OR APPRENTICES.—Under Article XIV of the convention, a student or apprentice, a nonresident alien who is a citizen of Belgium and who is temporarily present in the United States exclusively for the purposes of study or for acquiring experience of a business, technical, or similar nature, shall be exempt from United States tax with respect to amounts derived by him in taxable years beginning on or after January 1, 1953, and received during such years from without the United States as remittances for the purposes of his maintenance, education, studies, or training.

§ 504.116 CREDIT AGAINST UNITED STATES TAX FOR BELGIAN TAX—(a) *In general.*—(1) Notwithstanding any other provision of the convention (except as indicated in subparagraph (2) below), the United States, in determining the United States tax of a citizen or resident of the United States, or of a domestic corporation, may, under Article XII(1) of the convention, include in the basis upon which such tax is imposed all items of income taxable under the revenue laws of the United States, as though the convention had not come into effect. For example, despite the exemption from United States tax granted by Article IX(2) of the convention with respect to a copyright royalty derived from sources within the United States by a resident of Belgium, such royalty is includible in gross income and is subject to United States tax when so derived by such resident of Belgium who is a citizen of the United States.

(2) Notwithstanding the provisions of subparagraph (1) of this paragraph, the exclusion from gross income and the exemption from United States tax granted by Article X(1) of the convention with respect to wages, salaries, and similar compensation, and pensions and annuities paid by Belgium or its political subdivisions or territories, shall not be denied. See Article XII(1) of the convention.

(b) *Application of the credit.*—For the purpose of mitigating double taxation, Article XII(2) of the convention provides that a citizens of the United States, a citizen of Belgium who is a resident of the United States, or a domestic corporation, deriving income from sources within Belgium, shall be allowed a credit against United States tax for the amount of Belgian tax paid or accrued during the taxable year. This credit shall be made in accordance with the provisions of section 131 of the Internal Revenue Code of 1939 as in effect on September 9, 1953, but subject to the provisions of Article XX(1) of the convention.

§ 504.117 EXCHANGE OF INFORMATION—(a) *In general.*—By Articles XV, XVI, and XVIII of the convention, the United States and Belgium adopt the principle of exchange of such information as is necessary in carrying out the provisions of the convention, preventing fraud, or detecting practices which are aimed at reduction of the revenues of either country, but not including information which would be contrary to public policy or which would disclose any business, industrial, or trade secret. The information and correspondence relative to exchange of information may be transmitted directly by the Commissioner to the Directeur General.

(b) *Return of information by withholding agents.*—(1) To facilitate compliance with Article XV of the convention, every United States withholding agent shall make and file in duplicate with the

District Director of Internal Revenue, Baltimore 2, Maryland, an information return on Form 1042 Supplement, with respect to persons having addresses in Belgium, which shall be filed for the calendar year 1955 and subsequent calendar years. This return shall be filed simultaneously with Form 1042.

(2) There shall be reported on such Form 1042 Supplement all items of fixed or determinable annual or periodical income (and amounts described in section 402(a)(2), section 631 (b) and (c), and section 1235, Internal Revenue Code of 1954, which are considered to be gains from the sale or exchange of capital assets) derived from sources within the United States and paid to nonresident aliens (including nonresident alien individuals, fiduciaries, and partnerships) and to nonresident foreign corporations, whose addresses at the time of payment were in Belgium, including such items of income upon which, in accordance with the withholding regulations under the convention, no withholding of United States tax is required; except that any of such items which constitute interest in respect of which Form 1001–B or substitute Form 1001–B has been filed in duplicate with the withholding agent is not required to be reported on such Form 1042 Supplement.

(c) *Information to be furnished in ordinary course.*—In compliance with the provisions of Article XV of the convention, the Commission will transmit to the Directeur General, as soon as practicable after the close of the calendar year 1955 and of each subsequent calendar year during which the convention is in effect, the following information relating to such preceding calendar year:

(1) The duplicate copy of each available Form 1042 Supplement filed pursuant to paragraph (b) of this section; and

(2) The duplicate copy of each available ownership certificate, Form 1001–B, and substitute Form 1001–B, filed pursuant to the withholding regulations under the convention, in connection with coupon bond interest.

(d) *Information in specific cases.*—Under the provisions and limitations of Articles XVI and XVIII of the convention and upon the request of the Directeur General, the Commissioner shall furnish to the Directeur General information available to, or obtainable by, the Commissioner relative to the tax liability of any person under the revenue laws of Belgium in any case in which such information is necessary to the administration of the provisions of the convention or of statutory provisions against tax avoidance, or in which such information is necessary for the prevention of fraud.

§ 504.118 Double Taxation Claims.—(a) *In general.*—Under Article XIX of the convention, where the taxpayer presents proof that the action of the tax authorities of the United States or Belgium has resulted, or will result, in double taxation contrary to the provisions of the convention, he is entitled to lodge a claim with the country of which he is a citizen; or, if he is not a citizen of either country, with the country of which he is a resident; or, if the taxpayer is a corporation or other entity, with the country in which it is created or organized. The article provides that, should the taxpayer's claim be upheld, the competent authority of the country with which the

claim is lodged shall undertake to come to an agreement with the competent authority of the other country with a view to equitable avoidance of the double taxation in question.

(b) *Manner of filing claim.*—Such a claim on behalf of a United States citizen, corporation, or other entity, or on behalf of a resident of the United States who is not a Belgian citizen, shall be filed with the Commissioner. The claim shall be set up in the form of a letter addressed to "The Commissioner of Internal Revenue, Washington 25, D. C.", and shall show fully all facts and law on the basis of which the claimant alleges that such double taxation has resulted or will result. If the Commissioner determines that there is an appropriate basis for the claim under the convention, he shall take up the matter with the Directeur General with a view to arranging an agreement of the character contemplated by Article XIX.

§ 504.119 Beneficiaries of an Estate or Trust.—(a) If he otherwise satisfies the requirements of the respective articles concerned, a nonresident alien who is a resident of Belgium and who is a beneficiary of an estate or trust shall be entitled to the exemption from, or reduction in the rate of, United States tax granted by Articles VIII, VIIIA, and IX(2) of the convention with respect to dividends, interest, and patent royalties and other like amounts, to the extent that (1) any amount paid, credited, or required to be distributed by such estate or trust to such beneficiary is deemed to consist of such items, and (2) such items would, without regard to the convention, be includible in his gross income.

(b) For the determination of amounts which, without regard to the convention, are includible in the gross income of the beneficiary, see subchapter J of chapter 1 of the Internal Revenue Code of 1954 and the regulations thereunder.

§ 504.120 Members of a Partnership.—(a) *In general.*—Whether an individual, corporation, or other entity, a member of a partnership created or organized in Belgium or under Belgian laws, is subject to United States tax upon such person's distributive share of the income of such partnership depends upon both the status of the partnership and the status of such member.

(b) *Citizen partner.*—A citizen or resident of the United States, or a domestic corporation, is subject to United States tax upon such person's distributive share of the income of such partnership as though the convention had not come into effect (but subject to the provisions of § 504.116) even though other members, by reason of benefits granted by the convention, are not subject to United States tax upon their distributive share of such income.

(c) *Noncitizen partner.*—In any case in which income is derived from sources within the United States by a partnership created in Belgium or under Belgian laws, any member of such partnership who has a permanent establishment in the United States or who is either a nonresident alien not a resident of Belgium or is a foreign corporation which is not Belgian is not entitled, with respect to such member's distributive share of such income, to any benefit granted by the convention solely to nonresident aliens residing in Belgium or to Belgian corporations or other entities, having no permanent establishment in the United States. Conversely, any member of such partnership who

individually complies with the requirements for obtaining any such benefit will be entitled thereto with respect to such member's distributive share of such income. A member of a Belgian partnership which has a permanent establishment in the United States shall likewise be considered to have a permanent establishment in the United States.

§ 504.121 WITHHOLDING REGULATIONS.—For regulations pertaining to the release of excess tax withheld, and to exemption from or reduction in rate of withholding of United States tax at source, in the case of dividends, interest, patent and copyright royalties, film rentals, private pensions and annuities derived from sources within the United States by a nonresident alien who is a resident of Belgium, or by a Belgian corporation or other entity, see Treasury Decision 6056, approved December 4, 1953 (26 CFR (1939) 7.1100 through 7.1109) [C. B. 1954–1, 152].

RUSSELL C. HARRINGTON,
Commissioner of Internal Revenue.

Approved January 5, 1956.

H. CHAPMAN ROSE,
Acting Secretary of the Treasury.

(Filed by the Division of the Federal Register January 11, 1956, 8:45 a. m.)

UNITED STATES–FRANCE ESTATE TAX CONVENTION

A convention between the United States and France for the avoidance of double taxation and the prevention of fiscal evasion in the case of taxes on estates and inheritances and for the purpose of modifying and supplementing certain provisions of the convention between the two Governments relating to income taxes signed at Paris on July 25, 1939,[2] was signed at Paris on October 18, 1946. A supplementary protocol modifying this convention in certain respects was signed at Washington on May 17, 1948. The convention and protocol were approved for ratification by the United States Senate on June 2, 1948, and were ratified by the President on June 18, 1948. The convention and protocol were ratified by France on September 5, 1949. The instruments of ratification were exchanged at Washington on October 17, 1949, and the President proclaimed the convention and protocol on October 27, 1949.

The provisions of Title I of the convention and other provisions applicable with respect to taxes which are the subject of such title are effective on October 17, 1949, and are applicable solely to estates and inheritances in the case of persons who die on or after that date; and the provisions of Title II of the convention and other provisions applicable with respect to taxes which are the subject of the convention of July 25, 1939, and of Title II of the convention, except as otherwise provided, are effective on January 1, 1950.

Article II of the protocol provides that it shall become effective and continue effective as though it were an integral part of the convention. The convention and protocol read as follows:

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[2] C. B. 1946–1, 134.

TITLE I

TAXES ON ESTATES AND INHERITANCES

ARTICLE 1

(1) The taxes which are the subject of this title are:

(a) for the United States of America, the Federal estate tax, and

(b) for France, the tax on inheritances.

(2) This title shall also be applicable to all other taxes of a substantially similar character imposed by either contracting State after the signing of the present convention, or imposed by the government of any territory to which the present convention applies under Article 17.

(3) The present convention is concluded with reference to United States and French law in force on the day of its signature. Accordingly, if these laws are appreciably modified the competent authorities of the two States will consult together for the purposes of adapting the provisions of the present convention to such changes.

ARTICLE 2

(1) In this title, unless the context otherwise requires:

(a) The term "United States" means the United States of America, and when used in a geographical sense means only the States, the Territories of Alaska and of Hawaii, and the District of Columbia.

(b) The term "France", when used in a geographical sense, means only metropolitan France, excluding Algeria and the Colonies.

(c) The term "tax" means the French tax on inheritances or the Federal estate tax of the United States, as the context requires.

(2) In the application, by one of the contracting States, of the provisions of this title, any term which is not otherwise defined shall have, unless the context requires a different interpretation, the meaning which it has under the laws of that contracting State relating to the taxes which are the subject of this title.

ARTICLE 3

(1) For the purposes of this title, the question whether a decedent was domiciled in the territory of one of the contracting States at the time of his death shall be determined in conformity with the law in force in that territory.

(2) In the case of the death of a person domiciled in the territory of one of the contracting States, the situs of any of the following property or property rights shall, for the purpose of the imposition of the tax and for the purpose of the credit provided for in Article 5, be determined exclusively in accordance with the following rules:

(a) Real property shall be deemed to be situated at the place where the land involved is located. Real property includes leases of such property, unless such leases are of eighteen years' duration or less, but excludes mortgages and other liens on such property as security. The question whether any other property or right in property constitutes real property shall be determined in accordance with the law of the place where the land involved is located.

(b) Corporeal movable property, except as hereinafter prescribed, as well as bank notes and any other kind of money which is legal tender at the place of issuance, shall be deemed to be situated where it is physically located at the time of the decedent's death.

(c) Ships and aircraft shall be deemed to be situated at the place of registration or documentation of the ship or aircraft.

(d) The goodwill of a business firm (including for the purposes of this subparagraph rights in a lease other than one deemed to be real property under the provisions of subparagraph (a) of this Article) or the goodwill attached to the practice of one of the liberal professions shall be deemed to be situated where the business is carried on or the profession is practiced.

(e) Patents, trademarks and designs shall be deemed to be situated at the place where they are registered.

(f) Copyrights and rights or licenses to use any copyrighted material, patent, trademark or design shall be deemed to be situated at the place where the rights arising therefrom are exercisable.

(g) Shares in a corporation (including shares held by a nominee for the benefit of the decedent) shall be deemed to be situated at the place in which, or under the laws of which, such corporation was created or organized.

(h) Bills of exchange and checks shall be deemed to be situated at the place of the drawee's residence, and negotiable promissory notes at the place of residence of the maker.

(i) All property other than hereinbefore mentioned shall be deemed to be situated in the State in which the deceased person was domiciled at the time of his death.

ARTICLE 4

The contracting State which imposes tax in the case of a decedent who, at the time of his death, was not domiciled in its territory but was domiciled in the territory of the other contracting State:

(a) shall allow every abatement, exemption, deduction, or credit, which would be applicable under its law if the decedent had been domiciled in its territory, in an amount not less than the proportion thereof which the value of the property, situated according to Article 3 in such State and subject to the tax of such State, bears to the value of the property which would have been subject to the tax of such State if the decedent had been domiciled in its territory; and

(b) shall (except for the purpose of subparagraph (a) of this Article and for the purpose of any other proportionate allowance otherwise provided) take no account of property situated according to Article 3 outside its territory in determining the amount or rate of tax.

However, the provisions of this Article shall not apply to the tax imposed by the United States in the case of a deceased citizen of the United States.

ARTICLE 5

(1) The contracting State imposing tax in the case of a deceased person, who, at the time of his death, was domiciled in such State (or was a citizen thereof if such State is the United States), shall allow against its tax (as otherwise computed) a credit for the amount of the tax imposed by the other contracting State with respect to property situated in the territory of such other contracting State and included for tax purposes by both States, but the amount of credit shall not exceed the portion of the tax imposed by the former State which is attributable to such property. The provisions of this paragraph shall not apply with respect to any property referred to in paragraph (2) of this Article.

(2) If the decedent is regarded by each of the contracting States as being domiciled in its own territory, each State shall, in addition to the credit authorized by paragraph (1) of this Article, allow against its tax (as otherwise computed) a credit for the part of the tax imposed by the other State with respect to property included for tax purposes by both States and situated or deemed to be situated

(a) in the territory of both contracting States, or

(b) outside of both territories.

The total of the credits authorized by this paragraph shall be equal to the amount of tax imposed with respect to such property by the State imposing the smaller tax, and shall be divided between the two States in proportion to the amount of tax imposed by each of the two contracting States with respect to such property.

(3) For the purposes of this Article, the amount of the tax of each contracting State attributable to any designated property shall be ascertained after taking into account any applicable abatement, credit, remittance, diminution, or increase, as provided by its law, other than any credit authorized by this Article.

ARTICLE 6

(1) Any claim for a credit or a refund of tax founded on the provisions of this title shall be made within a period of five years from the date of the death of the decedent.

(2) Any such refund shall be made without payment of interest on the amount so refunded.

TITLE II

TAX ON INCOMES

ARTICLE 7

The provisions of the convention and protocol between the United States of America and the French Republic signed at Paris on July 25, 1939 are hereby modified and supplemented as follows:

(a) In the enumeration of French taxes to which the convention of July 25, 1939, applies the reference to the national tax on undistributed profits which is set forth as number (3) in Article 1(b) of Title I is eliminated as the tax has ceased to be imposed in France since January 1, 1941. The second paragraph of Article 15 of said convention is abrogated.

(b) For the purposes of Article 7 an individual resident of France deriving from sources within the United States rents from real property, or royalties in respect to mines, quarries, or other natural resources may elect for any taxable year to be subject to United States tax as if such resident were engaged in trade or business within the United States through a permanent establishment therein in such taxable year. For the purposes of Article 7 the term "royalties" as used in the second paragraph of such article shall, as to amounts paid on or after January 1, 1945, be deemed to include rentals in respect of motion picture films.

(c) Article 8 is amended by adding after the words "other State" in the first paragraph thereof the following: "(other than citizens of such other State").

(d) (1) Article 14, B, a) is amended by striking out "12" and inserting in lieu thereof "25". This subparagraph shall be deemed to be effective as of January 1, 1945, with respect to the taxation of income acquired since that date on which the French tax has not been collected.

(2) The last paragraph of Article 14, B, b) is abrogated and replaced by the following provisions:

"However, the provisions of the first and second paragraphs of Article 114 of the French Code on direct taxation relative to the taxation of aliens domiciled or resident in France shall continue to be applied."

(e) By adding immediately after Article 17 the following new article:

ARTICLE 17A

The American corporations affected by Article 17 of the convention of July 25, 1939, which remain subject to the provisions of Article 3 of the Decree of December 6, 1872 which were not placed under the special regime established by Articles 5 and 6 of the convention for the avoidance of double taxation between the United States of America and France signed April 27, 1932 may, during a new period of six months from the date of exchange of the instruments of ratification of the present convention, exercise with reference to past years the option provided in those two Articles under the conditions which they prescribe.

(f) Paragraph VIII of the Protocol is amended to read as follows:

VIII.

As used in this convention, the term "competent authority" or "competent authorities" means, in the case of the United States of America the Commissioner of Internal Revenue or his duly authorized representative, and in the case of France the Chef du Service de la Coordination des Administrations Financieres or his duly authorized representative.

TITLE III

ADMINISTRATIVE ASSISTANCE

ARTICLE 8

(1) With a view to a more effective imposition of the taxes referred to in Title I of the present convention and in the tax convention of July 25, 1939, and to the prevention of fraud in the case of such taxes, the contracting States agree that their competent authorities will exchange all the information which they

possess or can procure under their respective laws that may be of use to the competent authorities for these purposes. The information transmitted under the provisions of this convention by one of the contracting States to the other contracting State shall not be published, revealed or disclosed to any person except to the extent permitted under the laws of the latter State with respect to similar information.

(2) In no case shall the provisions of this title relating to disclosure of information in particular cases or to mutual assistance in the collection of taxes be construed so as to impose upon either of the contracting States the obligation to carry out administrative measures at variance with the regulations and practice of either contracting State or to supply particulars which are not procurable under its own legislation or information which is of such nature that it would involve violation of an industrial, business, or trade secret or compromise its security.

(3) The State to which application is made for information or assistance shall comply as soon as possible with the request addressed to it. If, for any of the reasons set forth above, it is unable to comply with such request it shall inform as soon as possible the State making the application.

ARTICLE 9

(1) In conformity with the provisions of the preceding Article the competent authorities of the United States will transmit without request to the competent authorities of the French Republic:

(a) As regards any person, corporation or other entity having an address in France and deriving from sources within the United States rents, dividends, interest, royalties (including income from authors' rights), income from trusts, salaries, wages, bonuses, pensions, annuities, or other fixed or determinable periodical income, the name and address of such person, corporation or other entity as well as the amount of such income.

(b) As regards—

(A) a decedent who was a citizen of, or domiciled in, the United States, any information disclosed by United States estate tax records relative to property of such decedent situated in France; and

(B) a decedent domiciled in France, any information disclosed by United States estate tax records relative to property of such decedent situated in the United States.

(c) Any particulars which the competent authorities of the United States may obtain from banks, savings banks or other similar institutions concernings assets belonging to individuals whose addresses are in France or to French corporations or other entities, as well as information on the amount of payments of coupons from securities which are made to the account of these persons.

(d) Any particulars which the competent authorities of the United States may obtain from inventories in the case of property passing on death concerning debts contracted with individuals whose addresses are in France or French corporations or other entities.

(2) The information referred to in subparagraph (a) of paragraph (1) of this Article will be transmitted as soon as possible after December 31 of each year. The information referred to in subparagraphs (b), (c) and (d) of paragraph (1) of this Article will be transmitted as soon as practicable in the course of audit of estate tax cases.

ARTICLE 10

(1) In conformity with the provisions of Article 8, and independently of the enumeration below, the competent authorities of the French Republic will transmit spontaneously to the competent authorities of the United States information which they can obtain on the existence of property belonging to the estates of persons, domiciled at the moment of their death either in France or in the United States or of citizens of the United States, and which may be taxable under the estate tax laws of the United States.

(2) They will furnish in particular to these authorities:

(a) the copy of the transcript of the report of the opening of safety boxes or sections of safety boxes which were rented by the decedents or their spouses if these persons were domiciled in the United States or if they were citizens thereof;

(b) the copy of the transcript of the reports of the inventory of the content of sealed envelopes and locked boxes deposited by said persons, with bankers, brokers or other persons receiving habitually deposits of this type;

(c) the copy of the lists of securities, cash or documents of evidences of value belonging to the estate of a person domiciled in the United States transmitted by corporations or companies, brokers, bankers, ministerial officers (notaries), business agents, custodians;

(d) the report of the opening of each individual or joint account opened with one of the persons designated under the preceding subparagraph and concerning one or more citizens of the United States.

(3) They will also furnish to these authorities:

(a) the name and address of each natural or juridical person having an address in the United States and drawing from sources situated in France income from immovables, dividends, interests, royalties, salaries, wages, bonuses, pensions, annuities, or other periodical (fixed or variable) incomes, accompanied by an indication for each of the said persons of the amount of this income;

(b) all information which they can obtain from banks, savings banks or other analogous institutions on assets belonging to persons who have an address in the United States or corporations or other United States juridical persons as well as information on the amount of payments of coupons from securities which are made to the account of these persons;

(c) all information which they can obtain from inventories at death concerning debts which are due to persons residing in the United States or corporations or other United States juridical persons.

(4) The information referred to in paragraph (2) and subparagraph (c) of paragraph (3) above will be transmitted as quickly as possible and as soon as it comes to the attention of the competent authorities of the French Republic; the information referred to under subparagraphs (a) and (b) of paragraph (3), as quickly as possible in the first six months of each year.

ARTICLE 11

The competent authorities of each of the contracting States shall be entitled to obtain from the competent authorities of the other contracting State information concerning concrete cases affecting natural or juridical persons as far as the application of the taxes referred to under Title I of the present convention and the taxes under the tax convention signed July 25, 1939 is concerned.

ARTICLE 12

(1) The two contracting States undertake to lend assistance and support to each other in the collection of the taxes to which the present convention or the convention of July 25, 1939, relates, together with interest, costs, and additions to the taxes and fines not being of a penal character according to the laws of the State requested, in the cases where the taxes are definitely due according to the laws of the State making the application.

(2) In the case of an application for enforcement of taxes, revenue claims of each of the contracting States which have been finally determined will be accepted for enforcement by the State to which application is made and collected in that State in accordance with the laws applicable to the enforcement and collection of its own taxes.

(3) The application will be accompanied by such documents as are required by the laws of the State making the application, to establish that the taxes have been finally determined.

(4) If the revenue claim has not been finally determined, the State to which application is made will take such measures of conservancy (including measures with respect to transfer of property of nonresident aliens) as are authorized by its laws for the enforcement of its own taxes.

ARTICLE 13

(1) The competent authorities of the two contracting States may prescribe regulations necessary to interpret and carry out the provisions of the present convention and the convention of July 25, 1939. With respect to those provisions relating to exchange of information and mutual assistance in the collection of taxes, such authorities may, by common agreement, prescribe rules concerning

matters of procedure, forms of application and replies thereto, conversion of currencies, transfer of sums collected, minimum amounts subject to collection, payment of costs of collection, and related matters.

(2) Should any difficulty or doubt arise as to the interpretation or application of the present convention or the convention of July 25, 1939, or their relationship to conventions between one of the contracting States and any other State, the competent authorities of the contracting States may settle the question by mutual agreement.

ARTICLE 14

Any taxpayer who shows proof that the action of the revenue authorities of the contracting States has resulted in double taxation in his case in respect of any of the taxes to which the present convention, or the convention of July 25, 1939, relates, shall be entitled to lodge a claim with the State of which he is a citizen or, if the taxpayer is a corporation or other entity, with the State in which it is created or organized. Should the claim be upheld, the competent authority of each State may come to an agreement with the competent authority of the other State with a view to equitable avoidance of the double taxation in question.

ARTICLE 15

As used in the present convention, the term "competent authorities" means, in the case of the United States of America, the Commissioner of Internal Revenue or his duly authorized representative, and, in the case of the French Republic, the Chef du Service de la Coordination des Administrations Financières or his duly authorized representative.

TITLE IV

GENERAL PROVISIONS

ARTICLE 16

Upon the coming into force of the present convention, the provisions of Articles 20 to 26, inclusive, constituting Title II, of the convention between the United States of America and the French Republic, signed at Paris on July 25, 1939, shall be superseded and replaced by the provisions of Articles 8 to 15, inclusive, constituting Title III, of the present convention to the extent that such provisions may be applicable with respect to the taxes which are the subject of the convention of July 25, 1939.

ARTICLE 17

(1) So long as the present convention shall be in force, either of the contracting States may, by written notification to the other contracting State through diplomatic channels, declare its desire that the operation of either

(a) Title 1, and other provisions of the present convention which may be applicable with respect to the taxes which are the subject of Title I, or

(b) the convention of July 25, 1939 as modified and supplemented by the present convention,

or both, shall extend to all or any of its colonies, overseas territories, protectorates, or territories under its mandate or trusteeship which impose taxes substantially similar to those which are the subject of Title I of the present convention or which are the subject of the convention of July 25, 1939, as the case may be.

(2) The provisions of the present convention, or of the convention of July 25, 1939 as modified and supplemented by the present convention, with respect to which a notification is given in accordance with paragraph (1) of this Article, shall apply to the territory or territories named in such notification,

(a) as to the taxes which are the subject of Title I of the present convention: in the case of persons who die on or after the date or dates specified in the notification (it being understood that such date or dates shall be not less than sixty days from the date of the notification), or, if no date is specified in respect of any such territory, on or after the date of such notification, or,

(b) as to the taxes which are the subject of the convention of July 25, 1939: on and after the first day of January following the date of the

notification (it being understood that such first day of January shall be not less than sixty from the date of the notification).

unless, before the date on which the provisions would otherwise be applicable to a particular territory, the contracting State to which the notification is given shall have informed the other contracting State, in writing through diplomatic channels, that it does not accept such notification in respect of that territory. In the absence of such an extension, the provisions which are the subject of the notification shall not apply to any such territory.

(3) At any time after the expiration of a period of one year from the effective date of an extension made by virtue of paragraphs (1) and (2) of this Article, either of the Contracting States may, by a written notice of termination given to the other Contracting State through diplomatic channels, terminate the application of the provisions to any of the territories of the former State to which such provisions have been extended; in which case,

(a) in so far as concerns estates or inheritances in the case of persons who die on or after the date or dates specified in such notice (it being understood that such date or dates shall be not less than sixty days from the date of such notice), or, if no date is specified, on or after the sixtieth day after the date of such notice, or

(b) in so far as concerns the application of the Convention of July 25, 1939 as modified and supplemented by the present Convention, on and after the first day of January following the date of such notice (it being understood that such first day of January shall be not less than sixty days from the date of the notice),

the provisions, as the case may be, shall cease to be applicable to the territory or territories named in such notice; provided, however, that this shall not affect the continued application of such provisions to the United States, to France, or to any other territory to which such provisions apply and which is not named in the notice of termination.

(4) For the application of any of the provisions to any territory to which it is extended by the United States or by the French Republic, references to "United States" or, as the case may be, "France", or to the territory of one (or of the other) contracting State, shall be construed to refer to the territory to which such provisions shall have been extended.

(5) For the purposes of the present convention, Algeria shall be considered to be a French territory to which the provisions of this Article shall apply.

ARTICLE 18

(1) The present convention shall be ratified and the instruments of ratification shall be exchanged at Washington as soon as possible.

(2) The provisions of Title I, and the other provisions of the present convention in so far as they may be applicable with respect to the taxes which are the subject of Title I, shall enter into force on the day of the exchange of instruments of ratification, and shall be applicable solely to estates or inheritances in the case of persons who die on or after that date.

(3) The provisions of Title II, and the other provisions of the present convention in so far as they may be applicable with respect to the taxes which are the subject of the convention of July 25, 1939 and of Title II of the present convention, shall, except as otherwise provided in the present convention, enter into force on the first day of January following the exchange of instruments of ratification.

ARTICLE 19

(1) The present convention shall remain in force for a minimum period of five years after the date of the exchange of the instruments of ratification.

(2) If, not less than six months before the expiration of such period of five years, neither of the contracting States shall have given to the other contracting State, through diplomatic channels, written notice of its intention to terminate the present convention, the convention shall remain in force after such period of five years until either of the contracting States shall have given notice of such intention, in which event

(a) the provisions of Title I, and the other provisions of the present convention in so far as they may be applicable with respect to the taxes which are the subject of Title I, shall not be effective as to estates or inheritances in the case of persons who die on or after the date (not being earlier than the sixtieth day after the date of the notice of termination) specified in

such notice, or, if no date is specified, on or after the sixtieth day after the date of such notice; and

(b) the provisions of Title II, and the other provisions of the present convention in so far as they may be applicable with respect to the taxes which are the subject of the convention of July 25, 1939 and of Title II of the present convention, shall not be effective on or after the first day of January following the expiration of a six-month period after the date of the notice of termination.

IN TESTIMONY WHEREOF, the Plenipotentiaries above-named have signed the present convention and affixed thereto their seals.

DONE at Paris, in duplicate, in the English and French languages, this 18th of October 1946.

PROTOCOL

The Government of the United States of America and the Government of the French Republic, desiring to conclude a supplementary Protocol modifying in certain respects the convention signed at Paris October 18, 1946, for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates and inheritances and for the purpose of modifying and supplementing certain provisions of the convention between the two Governments relating to income taxation signed at Paris on July 25, 1939,

Have agreed as follows:

ARTICLE I

(1) Article 12 of the convention of October 18, 1946, is amended by adding thereto the following paragraph:

(5) The assistance provided for in this Article shall not be accorded with respect to citizens, corporation or other entities of the State to which application is made nor with respect to estates of such citizens.

(2) For the purposes of Title I of the convention of October 18, 1946—

(a) The determination whether a citizen of the United States acquired a domicile in France will, for the purposes of the French tax on inheritances, be made in conformity with Article 103 of the French Civil Code as in effect on the date of signature of this Protocal.

(b) The determination whether a citizen of France acquired a domicile in the United States will, for the purposes of Federal estate taxes, be made in conformity with Section 81.5 of the United States Estate Tax Regulations as in effect on the date of signature of this Protocol.

(3) Article 9 of the convention between the two Governments relating to income taxation signed at Paris on July 25, 1939, is amended to read as follows:

ARTICLE 9

An individual who is a resident of one of the contracting States shall be exempt from tax by the other contracting State upon compensation for personal services (other than income from the exercise of a liberal profession) performed during the taxable year within such other contracting State (a) he is present in such other contracting State for a period or periods aggregating less than the taxable year and (b) such services are performed for or on behalf of a resident, corporation or other entity of the former contracting State.

This provision does not apply to the income referred to in Article 8.

(4) The provisions of Article 10 of the convention signed July 25, 1939 between the United States and France shall be applied on a reciprocal basis.

(5) Title I of the convention between the two Governments signed at Paris on July 25, 1939 is supplemented by the following Article:

ARTICLE 19A

In the case of taxes on property or on increment of property, the following provisions shall be applicable:

(1) If the property consists of:

(a) immovable property and accessories appertaining thereto;

(b) commercial or industrial enterprises, including maritime shipping and air transport undertakings;

the tax may be levied only in that contracting State which is entitled under the preceding Articles to tax the income from such property.

(2) In the case of all other forms of property, the tax may be levied only in the State of domicile. However, the value of furniture is taxable in the State of the residence to which the furniture appertains.

(3) In applying paragraph (2) above, the domicile of physical persons corresponds to the normal residence understood in the sense of permanent habitation; domicile of corporations or other juridical persons to the place of the site of their actual management.

(4) This Article shall become effective only as to taxes enacted on or after the date of exchange of the instruments of ratification of this Protocol.

ARTICLE II

(1) This Protocol shall be ratified and the instruments of ratification thereof shall be exchanged at Washington.

(2) This Protocol shall become effective and continue effective in accordance with Articles 18 and 19 of the convention of October 18, 1946 as though this Protocol were an integral part of that Convention.

IN WITNESS WHEREOF the undersigned Plenipotentiaries, being duly authorized thereto by their respective Governments, have signed this Protocol and have affixed thereto their seals.

DONE in duplicate, in the English and French languages, at Washington this 17th day of May, 1948.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA: [SEAL]

G. C. MARSHALL,

Secretary of State of the United States of America

FOR THE GOVERNMENT OF THE FRENCH REPUBLIC: [SEAL]

H. BONNET,

Ambassador Extraordinary and Plenipotentiary of the French Republic in Washington

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UNITED STATES–FRANCE ESTATE TAX CONVENTION

Rev. Rul. 56–251

The credit authorized by article 5(2) of the estate tax convention between the United States and France may not be applied against the tax imposed by the United States on shares of stock of corporations organized in countries other than the United States and France included in the gross estate of a citizen of the United States domiciled in France at the time of his death.

The relief from double taxation authorized by article 14 of the convention may be applied only where the action of the revenue authorities of the United States or France has resulted in double taxation contrary to the provisions of the convention.

Advice has been requested whether the credit authorized by article 5(2) of the estate tax convention between the United States and France, page 837, this Bulletin may be applied against the tax imposed by the United States on shares of stock of corporations organized in countries other than the United States and France which was included in the gross estate of a citizen of the United States domiciled in France at the time of his death, and, if not, whether, under such circumstances, the estate has a valid claim for relief under the provisions of article 14 of the convention.

Article 5 of the estate tax convention between the United States and France provides, in part, as follows:

(1) The contracting State imposing tax in the case of a deceased person, who, at the time of his death, was domiciled in such State (or was a citizen thereof if such State is the United States), shall allow against its tax (as otherwise computed) a credit for the amount of the tax imposed by the other contracting State with respect to property situated in the territory of such other contracting State and included for tax purposes by the both States, but the amount of credit shall not exceed the portion of the tax imposed by the former State which is attributable to such property. The provisions of this paragraph shall not apply with respect to any property referred to in paragraph (2) of this article.

(2) If the decedent is regarded by each of the contracting States as being domiciled in its own territory, each State shall, in addition to the credit authorized by paragraph (1) of this article, allow against its tax (as otherwise computed) a credit for the part of the tax imposed by the other State with respect to property included for tax purposes by both States and situated or deemed to be situated

(a) in the territory of both contracting States, or

(b) outside of both territories.

The total of the credits authorized by this paragraph shall be equal to the amount of tax imposed with respect to such property by the State imposing the smaller tax, and shall be divided between the two States in proportion to the amount of tax imposed by each of the two contracting States with respect to such property.

Article 5 of the convention authorizes two distinct types of credit. Paragraph (1) of article 5 authorizes credit in a case where the decedent was a citizen of the United States or a domiciliary of either or both of the contracting countries. This credit, which may be designated as the primary credit, is restricted to the tax attributable to property having a situs in either the United States or France. Paragraph (2) authorizes credit with respect to property deemed to be situated in both or outside of both countries. This credit, which may be designated as the secondary credit, is restricted to cases where the decedent is regarded by each of the contracting countries as having been domiciled in its territory.

Since the credit authorized by article 5(2) of the convention is restricted to cases where the decedent is regarded by each country as having been domiciled in its territory, no credit may be applied against the tax under the circumstances in this case.

Article 14 of the estate tax convention between the United States and France provides as follows:

Any taxpayer who shows proof that the action of the revenue authorities of the contracting States has resulted in double taxation in his case in respect of any of the taxes to which the present Convention, or the convention of July 25, 1939, relates, shall be entitled to lodge a claim with the State of which he is a citizen or, if the taxpayer is a corporation or other entity, with the State in which it is created or organized. Should the claim be upheld, the competent autority of each State may come to an agreement with the competent authority of the other State with a view to equitable avoidance of the double taxation in question.

In order to obtain relief under article 14 of the convention, it is essential that the taxpayer show proof that action of the revenue authorities of one of the contracting States has resulted in double taxation contrary to the provisions of the convention. Any other interpretation would render meaningless and, in effect, nullify specific provisions of the convention, such as those pertaining to situs of property and the allowance of credit. Under the circumstances in this case, the taxpayer has not established a basis for a claim under article 14 of the convention.

In view of the foregoing, it is held that the credit authorized by article 5(2) of the estate tax convention between the United States and France may not be applied against the tax imposed by the United States on shares of stock of corporations organized in countries other than the United States and France which are included in the gross estate of a citizen of the United States domiciled in France at the time of his death.

The relief from double taxation authorized by article 14 of the convention may be applied only where the action of the revenue authorities of the United States or France has resulted in double taxation contrary to the provisions of the convention.

UNITED STATES–NETHERLANDS INCOME TAX CONVENTION

T. D. 5778, Section 7.862: Visiting professors or teachers. Rev. Rul. 56–164

A resident of the Netherlands whose income derived from teaching in the United States was exempt from United States income tax under the provisions of Article XVII of the income tax convention between the United States and the Netherlands, and who has left the United States, may, upon his return, enter upon another exemption period of two years provided he has been absent from the United States for a period of not less than one year and he still meets the requirements of that article.

Advice has been requested whether a resident of the Netherlands whose income derived from teaching in the United States was exempt from United States income tax under the provisions of article XVII of the income tax convention between the United States and the Netherlands, Treasury Decision 5778, C. B. 1950–1, 92, at 97, may, after a period of absence from the United States, enter upon another exemption period.

Article XVII of the convention reads as follows:

Professors or teachers, residents of one of the contracting states, who, in accordance with agreements between the contracting states or between teaching establishments in the contracting states for the exchange of professors and teachers, visit the other contracting state to teach, for a maximum period of 2 years, in a university, college, or other teaching establishment in such other contracting state, shall not be taxed by such other state with respect to the remuneration which they receive for such teaching.

Language similar to that here under consideration is contained in article XVIII of the income tax convention between the United States and the United Kingdom, Treasury Decision 5569, C. B. 1947–2, 100, at 106. Up to that time, this provision had no counterpart in any previous tax convention. A technical memorandum of the Treasury Department on the convention was incorporated into the Senate Executive Report No. 6, 79th Congress, dated July 3, 1945. This memorandum, in referring to visiting professors and teachers, reads in pertinent part as follows:

* * * Its effect [article XVIII] is to exempt from United States tax, upon a reciprocal basis, compensation for personal services rendered in the United States by a resident of the United Kingdom who is temporarily present in the United States for the purpose of teaching at a United States university or other educational institution in the United States. The intent is to allow an exemp-

tion for 2 years in any event. * * * If he then leaves the United States on vacation but resumes his duties in the United States at the beginning of the school term in the fall * * * he is not exempt with respect to his remuneration earned thereafter. If, however, he leaves the United States for an entire year or more and then returns to the United States, it is the intendment of the article that he will then enter upon another exemption period of 2 years. * * *

Senate Executive Report No. 11, 80th Congress, 2d Session, contains the following language, "The [Netherlands] convention is designed to accomplish essentially the same objectives as income tax conventions now in force with Sweden, France, Canada and the United Kingdom."

In view of the foregoing, it is held that a resident of the Netherlands whose income derived from teaching in the United States was exempt from United States income tax in accordance with article XVII of the United States-Netherlands income tax convention and who has left the United States may, upon his return, enter upon another exemption period of two years provided he has been absent from the United States for a period of at least one year and he still meets the requirements of article XVII of the convention.

The principles herein set forth with respect to the United States–Netherlands income tax convention will also apply to other income tax conventions which contain language similar to that here considered.

UNITED STATES–SWITZERLAND INCOME TAX CONVENTION

T. D. 6149, Section 509.105: Industrial and commercial profits. Rev. Rul. 56–165

A resident of Switzerland who is in the United States for the purpose of demonstrating and selling logging equipment, together with the logs produced during the demonstrations, is carrying on an enterprise which is "engaged in trade or business in the United States through a permanent establishment situated therein" within the meaning of article III(1)(a) of the United States–Switzerland Tax Convention. Any income realized within the United States by such enterprise is subject to United States income tax.

A resident of Switzerland employed by such enterprise qualifies for exemption under article X(1)(a) of the convention with respect to payment for services performed in the United States as an employee of such enterprise, provided such employee is temporarily present in the United States for a period or periods not exceeding 183 days during the taxable year of the performance of such services.

Advice has been requested whether, under the provisions of the United States–Switzerland Income Tax Convention, Treasury Decision 6149, C. B. 1955–2, 814, a Swiss resident, who is in the United States with his specially trained employees, who are residents of Switzerland, to demonstrate the equipment which he manufactures, is engaged in trade or business within the United States through a permanent establishment and is, therefore, taxable on the income derived from the sale of the equipment and of articles produced during such demonstrations, even though he has no warehouse or other type of building from which to work. Advice has also been requested whether the Swiss employees qualify for exemption under article X(1)(a) of the Convention on the compensation for their labor or

personal services performed in the United States as employees of such resident of Switzerland.

Article III(1)(a) of the United States–Switzerland Income Tax Convention, *supra*, provides as follows:

> A Swiss enterprise shall not be subject to taxation by the United States in respect of its industrial and commercial profits unless it is engaged in trade or business in the United States through a permanent establishment situated therein. If it is so engaged the United States may impose its tax upon the entire income of such enterprise from sources within the United States.

Article II(1)(c) of the convention provides in effect that the term "permanent establishment" means a branch, office, factory, workshop, warehouse or other fixed place of business; but, the maintenance of a warehouse for convenience of delivery and not for purposes of display does not, of itself, constitute a permanent establishment.

Article II(1)(f) of the convention provides in part as follows:

> The term "Swiss enterprise" means an industrial or commercial enterprise or undertaking carried on in Switzerland by an individual resident in Switzerland or by a Swiss corporation or other entity; * * *.

Article X(1) of the convention provides as follows:

> An individual resident of Switzerland shall be exempt from United States tax upon compensation for labor or personal services performed in the United States (including the practice of the liberal professions and rendition of services as director) if he is temporarily present in the United States for a period or periods not exceeding a total of 183 days during the taxable year and either of the following conditions is met:
>
> (a) his compensation is received for such labor or personal services performed as an employee of, or under contract with, a resident or corporation or other entity of Switzerland, or
>
> (b) his compensation received for such labor or personal services does not exceed $10,000.

Although the enterprise under consideration has no warehouse or other type of building in the United States in which or from which it is conducted, the equipment involved is logging equipment which is necessarily demonstrated in particular forest areas and was brought here for purposes of such demonstration with the expectation that orders would be obtained for such equipment. It is anticipated that the demonstration and sales activities will continue for approximately two years.

Accordingly, it is held that a resident of Switzerland, who is engaged in the United States in demonstrating and selling logging equipment, together with the logs produced during such demonstrations, is carrying on an enterprise which is "engaged in trade or business in the United States through a permanent establishment situated therein" within the meaning of article III(1)(a) of the United States–Switzerland Tax Convention. Therefore, income realized from sources within the United States by such enterprise is subject to United States income tax.

It is further held that a resident of Switzerland brought into this country by such Swiss employer to aid in the demonstration of its equipment qualifies for exemption under article X(1)(a) of the convention with respect to payment for such services performed in the United States, provided such employee is temporarily present in the United States for a period or periods not exceeding 183 days during the taxable year of the performance of such services.

UNITED STATES–UNITED KINGDOM INCOME TAX CONVENTION

T. D. 5569, C. B. 1947–2, 100, Section 7.521: Rev. Rul 56–24
Compensation for labor or personal services.
(Also Part I, Section 871.)

The word "day" as used in relation to article XI(1) of the income tax convention between the United States and the United Kingdom of Great Britain and Northern Ireland, T. D. 5569, C. B. 1947–2, 100, with respect to the exempt status of compensation for personal services performed by a resident of the United Kingdom who is present in the United States for a period or periods not exceeding in the aggregate 183 days during the taxable year, is interpreted for United States income tax purposes to mean a day during any portion of which the resident of the United Kingdom was physically present within the United States. This interpretation will apply equally to all income tax conventions containing similar provisions.

I. T. 3876, C. B. 1947–2, 120, supplemented.

SUBPART B.—LEGISLATION

PUBLIC LAW 396, EIGHTY-FOURTH CONGRESS
[CHAPTER 15, SECOND SESSION]
H. R. 4582 [1]

An Act to amend the Internal Revenue Code of 1954 with respect to deductions from gross income of amounts contributed to employees trusts.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That a new paragraph be added to section 381(c) of the Internal Revenue Code of 1954 to read as follows:

(20) CARRY-OVER OF UNUSED PENSION TRUST DEDUCTIONS IN CERTAIN CASES.—Notwithstanding the other provisions of this section, or section 394(a), a corporation which has acquired the properties and assumed the liabilities of a wholly owned subsidiary shall be considered to have succeeded to and to be entitled to take into account contributions of the subsidiary to a pension plan, and shall be considered to be the distributor or transferor corporation after the date of distribution or transfer (but not for taxable years with respect to which this paragraph does not apply) for the purpose of determining the amounts deductible under section 404 with respect to contributions to a pension plan if—

(A) the corporate laws of the State of incorporation of the subsidiary required the surviving corporation in the case of merger to be incorporated under the laws of the State of incorporation of the subsidiary; and

(B) the properties were acquired in a liquidation of the subsidiary in a transaction subject to section 112(b)(6) of the Internal Revenue Code of 1939.

SEC. 2. The amendments made by the first section of this Act shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

Approved January 28, 1956.

PUBLIC LAW 397, EIGHTY-FOURTH CONGRESS
[CHAPTER 16, SECOND SESSION]
H. R. 5428 [2]

An Act to amend the Internal Revenue Code of 1939 with respect to the period of limitation for filing claims by certain transferees and fiduciaries for credit or refund of income taxes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 311(b)(4) of the Internal Revenue Code of 1939 is hereby amended by inserting "(A)" after "(4)" and by adding at the end thereof the following:

(B) For the purpose of determining the period of limitation on credit or refund to the transferee or fiduciary of—

(i) overpayments of tax made by such transferee or fiduciary, or

(ii) overpayments of tax made by the transferor of which the transferee or fiduciary is legally entitled to credit or refund,

[1] House Report No. 1594, page 924 this Bulletin; Senate Report No. 1375, page 925 this Bulletin.

[2] House Report No. 1448, page 925 this Bulletin; Senate Report No. 1376, page 927 this Bulletin.

the agreement referred to in subparagraph (A) and any extension thereof shall be deemed an agreement and extension thereof referred to in section 322(b)(3).

(C) If the agreement referred to in subparagraph (A) is executed after the expiration of the period of limitation for assessment against the taxpayer with reference to whom the liability of such transferee or fiduciary arises, then, in applying the limitations under section 322(b)(3) on the amount of the credit or refund, the periods specified in section 322(b)(3) shall be increased by the period from the date of such expiration to the date of the agreement.

SEC. 2. This Act shall be effective in all circumstances in which it would have been effective if it had been enacted on August 17, 1954.

Approved January 28, 1956.

PUBLIC LAW 398, EIGHTY-FOURTH CONGRESS
[CHAPTER 17, SECOND SESSION]
H. R. 7036 [3]

An Act to amend section 37 of the Internal Revenue Code of 1954 with respect to the earned income limitation on retirement income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 37(d)(2) of the Internal Revenue Code of 1954 (relating to limitation on retirement income) is hereby amended to read as follows:

(2) in the case of any individual who has not attained the age of 72 before the close of the taxable year, any amount of earned income (as defined in subsection (g))—

(A) in excess of $900 received by the individual in the taxable year if such individual has not attained the age of 65 before the close of the taxable year, or

(B) in excess of $1,200 received by the individual in the taxable year if such individual has attained the age of 65 before the close of the taxable year.

SEC. 2. The amendment made by the first section of this Act shall apply only with respect to taxable years beginning after December 31, 1955.

Approved January 28, 1956.

PUBLIC LAW 399, EIGHTY-FOURTH CONGRESS
[CHAPTER 18, SECOND SESSION]
H. R. 7282 [4]

An Act relating to the allowance of the credits for dividends received, for dividends paid, and for a Western Hemisphere trade corporation in computing the alternative tax of a corporation with respect to its capital gains.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 117(c)(1)(A) of the Internal Revenue Code of 1939 is hereby amended by inserting after the word "reduced" the following: "(except for

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[3] House Report No. 1595, page 946 this Bulletin; Senate Report No. 1377, page 948 this Bulletin.

[4] House Report 1356, page 981 this Bulletin; Senate Report No. 1378, page 982 this Bulletin.

the purposes of determining the credits allowable under subsections (b), (h), and (i) of section 26)".

SEC. 2. The amendment made by section 1 shall be applicable with respect to taxable years beginning after December 31, 1951, and before January 1, 1954. No interest shall be allowed or paid on any overpayment resulting from such amendment.

Approved January 28, 1956.

PUBLIC LAW 400, EIGHTY-FOURTH CONGRESS
[CHAPTER 19, SECOND SESSION]
H. R. 7364 [5]

An Act relating to the application of the documentary stamp tax to transfers of certain obligations paid for in installments.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That effective as of January 1, 1955, section 4332 of the Internal Revenue Code of 1954 (relating to exemption from tax on sales or transfers of certificates of indebtedness) is hereby amended by relettering subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

(b) INSTALLMENT PURCHASE OF OBLIGATIONS.—The tax imposed by section 4331 shall not apply to any instrument under the terms of which the obligee is required to make payment therefor in installments and is not permitted to make in any year a payment of more than 20 percent of the cash amount to which entitled upon maturity of the instrument.

Approved January 28, 1956.

PUBLIC LAW 408, EIGHTY-FOURTH CONGRESS
[CHAPTER 36, SECOND SESSION]
H. R. 7094 [6]

An Act To amend section 120 of the Internal Revenue Code of 1939 (relating to unlimited deduction for charitable contributions).

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 120 of the Internal Revenue Code of 1939 (relating to unlimited deduction for charitable and other contributions) is hereby amended by striking out "in each of the ten preceding taxable years" and inserting in lieu thereof "in eight of the ten preceding taxable years".

SEC. 2. (a) Except as provided in subsections (b), (c), and (d), the amendment made by the first section of this Act shall apply to all taxable years to which the Internal Revenue Code of 1939 applies.

(b) Notwithstanding any other provision of law, credit for any overpayment resulting from the amendment made by the first section of this Act shall not be allowed, and the refund of any such overpay-

[5] House Report No. 1497, page 982 this Bulletin; Senate Report No. 1379, page 983 this Bulletin.

[6] House Report No. 1596, page 952 this Bulletin; Senate Report No. 1403, page 953 this Bulletin.

ment shall be made only if it is established to the satisfaction of the Secretary of the Treasury or his delegate—

(1) in the case of a taxpayer who has not died at the time the refund is made, that the amount of such refund is to be paid forthwith as a charitable contribution (as defined in section 170(c) of the Internal Revenue Code of 1954), or

(2) in the case of a taxpayer who has died at the time the refund is made, that (A) an amount equal to the amount of the refund, under the terms of the decedent's will, will be transferred to any person or organization described in section 2055 of the Internal Revenue Code of 1954, and (B) an amount equal to the amount of such transfer is deductible from the value of the gross estate under such section or the corresponding provisions of the Internal Revenue Code of 1939.

No interest shall be paid upon any overpayment resulting from the amendment made by the first section of this Act.

(c) The amount of any refund made under this Act, and the payment or transfer of such amount as described in paragraph (1) or (2) of subsection (b), shall not be taken into account in determining any liability of the taxpayer or his estate for income tax or estate tax under the Federal income tax and estate tax laws.

(d) If a claim for refund relates to an overpayment on account of the amendment made by the first section of this Act, in lieu of the three-year period of limitation prescribed in section 322(b)(1) of the Internal Revenue Code of 1939, the period shall be seven years from the date prescribed by law for filing the return for the year with respect to which the claim is made. In the case of a claim described in this subsection, the amount of the refund may exceed the portion of the tax paid within the period prescribed in paragraph (2) or (3), whichever is applicable of section 322(b) of such code, to the extent of the amount of the overpayment attributable to the amendment made by the first section of this Act.

Approved February 15, 1956.

PUBLIC LAW 414, EIGHTY-FOURTH CONGRESS
[CHAPTER 63, SECOND SESSION]
H. R. 2667 [7]

An Act To amend section 208 (b) of the Technical Changes Act of 1953, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 208 (b) of the Technical Changes Act of 1953 [C. B. 1953–2, 485] is amended by striking out "1950" and inserting in lieu thereof "1947".

(b) The amendment made by subsection (a) shall be effective as if enacted as a part of section 208 (b) of the Technical Changes Act of 1953.

SEC. 2. Section 2053 of the Internal Revenue Code of 1954 (relating to deductions from the gross estate for expenses, indebtedness, and

[7] House Report No. 1605, page 919 this Bulletin; Senate Report No. 1401, page 920 this Bulletin.

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taxes) is hereby amended by redesignating subsection (d) to be subsection (e) and by adding after subsection (c) a new subsection as follows:

(d) CERTAIN STATE DEATH TAXES.—

(1) GENERAL RULE.—Notwithstanding the provisions of subsection (c)(1)(B) of this section, for purposes of the tax imposed by section 2001 the value of the taxable estate may be determined if the executor so elects before the expiration of the period of limitation for assessment provided in section 6501, by deducting from the value of the gross estate the amount (as determined in accordance with regulations prescribed by the Secretary or his delegate) of any estate, succession, legacy or inheritance tax imposed by a State or Territory or the District of Columbia, or any possession of the United States, upon a transfer by the decedent for public, charitable, or religious uses described in section 2055 or 2106(a)(2). The election shall be exercised in accordance with regulations prescribed by the Secretary or his delegate.

(2) CONDITION FOR ALLOWANCE OF DEDUCTION.—No deduction shall be allowed under paragraph (1) for a State death tax specified therein unless the decrease in the tax imposed by section 2001 which results from the deduction provided for in paragraph (1) will inure solely for the benefit of the public, charitable, or religious transferees described in section 2055 or section 2106(a)(2). In any case where the tax imposed by section 2001 is equitably apportioned among all the transferees of property included in the gross estate, including those described in sections 2055 and 2106(a)(2) (taking into account any exemptions, credits, or deductions allowed by this chapter), in determining such decrease, there shall be disregarded any decrease in the Federal estate tax which any transferees other than those described in sections 2055 and 2106(a)(2) are required to pay.

(3) EFFECT OF DEDUCTION ON CREDIT FOR STATE DEATH TAXES.—See section 2011(e) for the effect of a deduction taken under this subsection on the credit for State death taxes.

SEC. 3. Section 2011 of the Internal Revenue Code of 1954 is amended by adding after subsection (d) a new subsection as follows:

(e) LIMITATION IN CASES INVOLVING DEDUCTION UNDER SECTION 2053(d).—In any case where a deduction is allowed under section 2053(d) for an estate, succession, legacy, or inheritance tax imposed upon a transfer for public, charitable, or religious uses described in section 2055 or 2106(a)(2), the allowance of the credit under this section shall be subject to the following conditions and limitations:

(1) The taxes described in subsection (a) shall not include any estate, succession, legacy, or inheritance tax for which a deduction is allowed under section 2053(d).

(2) The credit shall not exceed the lessor of—

(A) the amount stated in subsection (b) on a taxable estate determined by allowing the deduction authorized by section 2053(d), or

(B) that proportion of the amount stated in subsection (b) on a taxable estate determined without regard to the deduction authorized by section 2053(d) as (i) the amount of the taxes described in subsection (a), as limited by the provisions of paragraph (1) of this subsection, bears to (ii) the amount of the taxes described in subsection (a) before applying the limitation contained in paragraph (1) of this subsection.

(3) If the amount determined under subparagraph (B) of paragraph (2) is less than the amount determined under subparagraph (A) of that paragraph, then for purposes of subsection (d) such lesser amount shall be the maximum credit provided by subsection (b).

SEC. 4. The amendments to the Internal Revenue Code of 1954 made by sections 2 and 3 of this Act, and provisions having the same effect as this amendment, which shall be considered to be included in chapter 3 of the Internal Revenue Code of 1939, shall apply to the estates of all decedents dying after December 31, 1953.

Approved February 20, 1956.

PUBLIC LAW 417, EIGHTY-FOURTH CONGRESS
[CHAPTER 66, SECOND SESSION]
H. R. 7054 [8]

An Act To amend the Internal Revenue Code of 1939 to provide a credit against the estate tax for Federal estate taxes paid on certain prior transfers.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subpart I of part II of subchapter A of chapter 3 of the Internal Revenue Code of 1939 (relating to computation of estate tax) is hereby amended by adding at the end thereof the following new section:

"SEC. 814. CREDIT FOR TAX ON CERTAIN PRIOR TRANSFERS.

"(a) GENERAL RULE.—If the executor so elects, the tax imposed by sections 810 and 935 in the case of a decedent (but only if the decedent was a citizen or resident of the United States at the time of his death) dying after December 31, 1951, shall be credited with all or a part of the amount of the Federal estate tax paid with respect to the transfer of property (including property passing as a result of the exercise or nonexercise of a power of appointment) to the decedent by or from a person (herein designated as a 'transferor') who was the spouse of the decedent at the time of such person's death and who died within two years before the decedent's death. The credit shall be the amount determined under subsections (b) and (c).

"(b) COMPUTATION OF CREDIT.—Subject to the limitation prescribed in subsection (c), the credit provided by this section shall be an amount which bears the same ratio to the estate tax paid (adjusted as indicated hereinafter) with respect to the estate of the transferor as the value of the property transferred bears to the net estate of the transferor (determined for purposes of the tax imposed by section 935) decreased by any death taxes paid with respect to such estate and increased by the exemption provided for by section 935(c) in determining the net estate of the transferor for purposes of the estate tax. For purposes of the preceding sentence, the estate tax paid shall be the Federal estate tax paid increased by any credits allowed against such estate tax under sections 813(a) and 936(b) on account of gift tax, and for any credits allowed against such estate tax under this section on account of prior transfers where the transferor acquired property from a person who died within two years before the death of the decedent.

"(c) LIMITATION ON CREDIT.—

"(1) IN GENERAL.—The credit provided in this section shall not exceed the amount by which—

"(A) the estate tax imposed by sections 810 and 935 (after deducting the credits for State death taxes, gift tax, and foreign death taxes provided for in sections 810, 813, and 936) computed without regard to this section, exceeds

"(B) such tax computed by excluding from the decedent's gross estate the value of such property transferred and, if applicable, by making the adjustment hereinafter indicated.

If any deduction is otherwise allowable under section 812(d) (relating to charitable deduction) then, for the purpose of the computation indicated in subparagraph (B), the amount of such deduction shall be reduced by that part of such deduction which the value of such property transferred bears to the decedent's entire gross estate reduced by the deductions allowed under section 812(b) (relating to deduction for expenses, losses, etc.). For purposes of this section, the value of such property transferred shall be the value as provided for in subsection (d) of this section.

"(2) TWO OR MORE TRANSFERORS.—If the credit provided in this section relates to property received from two or more transferors, the limitation provided in paragraph (1) of this subsection shall be computed by aggregating the value of the property so transferred to the decedent. The aggregate limitation so determined shall be apportioned in accordance with the value of the property transferred to the decedent by each transferor.

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[8] House Report No. 1495, page 948 of this Bulletin; Senate Report No. 1402, page 950 of this Bulletin.

"(d) VALUATION OF PROPERTY TRANSFERRED.—The value of property transferred to the decedent shall be the value used for the purpose of determining the Federal estate tax liability of the estate of the transferor but—

"(1) there shall be taken into account the effect of the tax imposed by sections 810 and 935, or any estate, succession, legacy, or inheritance tax, on the net value to the decedent of such property;

"(2) where such property is encumbered in any manner, or where the decedent incurs any obligation imposed by the transferor with respect to such property, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to the decedent of such property was being determined; and

"(3) if the decedent was the spouse of the transferor at the time of the transferor's death, the net value of the property transferred to the decedent shall be reduced by the amount allowed under section 812(e) (relating to marital deductions) as a deduction from the gross estate of the transferor.

"(e) PROPERTY DEFINED.—For purposes of this section, the term 'property' includes any beneficial interest in property, including a general power of appointment (as defined in section 811(f)).

"(f) DENIAL OF DEDUCTION FOR PROPERTY PREVIOUSLY TAXED.—If the executor elects the credit provided by this section, the deduction provided by section 812(c) shall not be allowed."

SEC. 2. No interest shall be allowed or paid on any overpayment resulting from the amendment made by the first section of this Act.

Approved February 20, 1956.

PUBLIC LAW 429, EIGHTY-FOURTH CONGRESS
[CHAPTER 83, SECOND SESSION]
H. R. 7201 [9]

An Act relating to the taxation of income of insurance companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act be cited as the "Life Insurance Company Tax Act for 1955".

SEC. 2. REVISION OF FORMULAS FOR TAXING INCOME OF LIFE INSURANCE COMPANIES.

Part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 is hereby amended to read as follows:

PART I.—LIFE INSURANCE COMPANIES

Subpart A. 1955 formula.
Subpart B. 1942 formula.
Subpart C. Miscellaneous provisions.

SUBPART A.—1955 FORMULA

Sec. 801. Definition of life insurance company.
Sec. 802. Tax imposed for 1955.
Sec. 803. Income and deductions.
Sec. 804. Reserve and other policy liability deduction.
Sec. 805. Special interest deduction.

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

(a) LIFE INSURANCE COMPANY DEFINED.—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—

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[9] House Report No. 1098, page 954 this Bulletin; Senate Report No. 1571, page 967 this Bulletin.

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) 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 (as defined in subsection (c)).

(b) LIFE INSURANCE RESERVES DEFINED.—

(1) IN GENERAL.—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) 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.

(2) RESERVES MUST BE REQUIRED BY LAW.—Except—

(A) 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

(B) as provided in paragraph (3),

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

(3) ASSESSMENT COMPANIES.—In the case of an assessment life insurance company or association, the term "life insurance reserves" includes—

(A) sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and

(B) 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.

(4) AMOUNT OF RESERVE.—For purposes of this subsection, subsection (a), and subsection (c), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

(c) TOTAL RESERVES DEFINED.—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums and unpaid losses not included in life insurance reserves, and

(3) all other insurance reserves required by law.

(d) ADJUSTMENTS IN RESERVES FOR POLICY LOANS.—For purposes only of determining under subsection (a) whether or not an insurance company is a life insurance company, the life insurance reserves, and the total reserves, shall each be reduced by an amount equal to the mean of the aggregates, at the beginning and end of the taxable year, of the policy loans outstanding with respect to contracts for which life insurance reserves are maintained.

(e) BURIAL AND FUNERAL BENEFIT INSURANCE COMPANIES.—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 this part but shall be taxable under section 821 or section 831.

SEC. 802. TAX IMPOSED FOR 1955.

(a) TAX IMPOSED.—A tax is hereby imposed for each taxable year beginning in 1955 on the income of every life insurance company. Except as provided in subsection (c), such tax shall consist of a normal tax (computed under section 11(b)) and a surtax (computed under section 11(c)) on the sum of—

(1) the life insurance taxable income (as defined in subsection (b)), plus

(2) the nonlife insurance taxable income (as defined in subsection (f)).

(b) LIFE INSURANCE TAXABLE INCOME DEFINED.—For purposes of this subpart, the term "life insurance taxable income" means the net investment income (as defined in section 803(c)), minus the sum of—

(1) the net investment income allocable to non-life insurance reserves (determined under section 804(d)),

(2) the reserve and other policy liability deduction (determined under section 804), and

(3) the special interest deduction, if any, allowed by section 805.

(c) ALTERNATIVE TAX IN THE CASE OF COMPANIES HAVING NON-LIFE INSURANCE RESERVES.—

(1) IN GENERAL.—In the case of a life insurance company which has non-life insurance reserves, the tax imposed by subsection (a) of this section for any taxable year beginning in 1955 shall be the tax computed under such subsection (or under section 1201(a) if applicable) or the tax computed under paragraph (2) of this subsection, whichever is the greater.

(2) ALTERNATIVE 1 PERCENT TAX ON NON-LIFE INSURANCE BUSINESS.—The tax referred to in paragraph (1) is a tax equal to the sum of the following:

(A) A partial tax consisting of a normal tax (computed under section 11(b)) and a surtax (computed under section 11(c)) on the life insurance taxable income.

(B) A partial tax consisting of—

(i) 1 percent of the amount which bears the same ratio to the gross investment income (reduced by the deduction for wholly-exempt interest allowed by section 803(c)(1)) as the non-life insurance reserves bear to the qualified reserves (determined under section 804 (c)), plus

(ii) 1 percent of the excess of the amount by which the net premiums on contracts meeting the requirements of section 804(d)-(2)(A) exceed the dividends to policyholders on such contracts. For purposes of this clause, net premiums, and dividends to policyholders, shall be computed in the manner provided in section 823.

(d) DEDUCTIONS FOR PARTIALLY TAX-EXEMPT INTEREST.—

(1) COMPUTATIONS UNDER SUBSECTION (a).—For purposes of computing the normal tax under subsection (a), there shall be allowed as a deduction an amount which bears the same ratio to the amount of the deduction provided by section 242 for partially tax-exempt interest as (A) the sum of the life insurance taxable income and the net investment income allocable to non-life insurance reserves bears to (B) the net investment income.

(2) COMPUTATIONS UNDER SUBSECTION (c)(2)(A).—In computing the normal tax for purposes of subsection (c)(2)(A), there shall be allowed as a deduction an amount which bears the same ratio to the amount of the deduction provided by section 242 for partially tax-exempt interest as (A) the life insurance taxable income bears to (B) the net investment income.

(e) ALTERNATIVE TAX ON CAPITAL GAINS.—In the case of a life insurance company which has non-life insurance reserves, the term "excess" used in section 1201(a) (relating to alternative tax on capital gains of corporations) means, for purposes of section 1201(a), an amount which bears the same ratio to the excess described in such section as the non-life insurance reserves (determined under section 804(d)) bear to the qualified reserves (determined under section 804(c)). For purposes of any such computation, a net capital loss for any taxable year beginning before January 1, 1955, shall not be taken into account.

(f) NON-LIFE INSURANCE TAXABLE INCOME DEFINED.—For purposes of this subpart, the term "non-life insurance taxable income" means the net investment income allocable to non-life insurance reserves (determined under section 804(d))—

(1) increased by an amount which bears the same ratio to the net capital gain as the non-life insurance reserves bear to the qualified reserves; and

(2) decreased by an amount which bears the same ratio to the total of the deductions provided in sections 243, 244, and 245 as the non-life insurance reserves bear to the qualified reserves.

In computing a net capital gain for purposes of paragraph (1) of this subsection, a net capital loss for any taxable year beginning before January 1, 1955, shall not be taken into account.

SEC. 803. INCOME AND DEDUCTIONS.

(a) APPLICATION OF SECTION.—The definitions and rules contained in this section shall apply only in the case of life insurance companies.

(b) GROSS INVESTMENT INCOME.—For purposes of this part, the term "gross investment become" means the sum of the following:

(1) The gross amount of income received or accrued from—

(A) interest, dividends, rents, and royalties,

(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interests, rents, or royalties, and

(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

(2) The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

In computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(c) NET INVESTMENT INCOME DEFINED.—The term "net investment income" means the gross investment 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.—

(A) Investment expenses paid or accrued during the taxable year.

(B) If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed—

(i) 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

(ii) one-fourth of the amount by which the net investment income (computed without any deduction for investment expenses allowed by this paragraph, or for tax-free interest allowed by paragraph (1)) 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 (as provided in section 164), and other expenses, paid or accrued during the taxable year exclusively on or with respect to the real estate owned by the company. No deduction shall be allowed under this paragraph for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property.

(4) DEPRECIATION.—The depreciation deduction allowed by section 167.

(5) DEPLETION.—The deduction allowed by section 611 (relating to depletion).

(6) TRADE OR BUSINESS DEDUCTIONS.—The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner; except that for purposes of this paragraph—

(A) There shall be excluded losses from—

(i) sales or exchanges of capital assets,

(ii) sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(iii) 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 thereaf) of property used in the trade or business (as so defined).

(B) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account.

(C) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in part VIII of subchapter B, shall not be allowed.

(d) RENTAL VALUE OF REAL ESTATE.—The deduction under subsection (c) (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.

(e) AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—The gross investment income, the deduction for wholly-exempt interest allowed by 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 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.

SEC. 804. RESERVE AND OTHER POLICY LIABILITY DEDUCTION.

(a) GENERAL RULE.—Except as provided in subsection (b), for purposes of this subpart the term "reserve and other policy liability deduction" means the sum of the amounts determined by applying the following percentages to the excess of the net investment income over the net investment income allocable to non-life insurance reserves (determined under subsection (d)):

(1) 87.5 percent of so much of such excess as does not exceed $1,000,000; and

(2) 85 percent of so much of such excess as exceeds $1,000,000.

(b) MAXIMUM DEDUCTION.—

(1) IN GENERAL.—The reserve and other policy liability deduction shall in no case exceed that amount which is equal to the sum of the following:

(A) the amount equal to 2 times the amount determined under paragraph (1) of section 805(c) (relating to required interest on life insurance reserves);

(B) the amount determined under paragraph (2) of section 805(c) (relating to required interest on reserves for deferred dividends);

(C) the amount of the interest paid (as defined in section 805(d));

(D) the dividends to policyholders paid or declared (other than dividends on contracts meeting the requirements of subsection (d)(2)(A)); and

(E) in the case of a mutual assessment life insurance company or association, the amount equal to 2 times whichever of the following is the lesser: (i) the amount of the net investment income on life insurance reserves described in subparagraph (A) or (B) of section 801(b)(3), or (ii) 3 percent of the life insurance reserves so described,

reduced by the amount of the adjustment for policy loans provided in paragraph (2) of this subsection. For purposes of subparagraph (D) 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.

(2) REDUCTION FOR CERTAIN POLICY LOANS.—The adjustment described in paragraph (1) of this subsection shall be an amount equal to—

(A) the mean of the aggregates, at the beginning and end of the taxable year, of the outstanding policy loans with respect to contracts for which life insurance reserves are maintained, multiplied by

(B) the average rate of interest applicable to life insurance reserves.

For purposes of subparagraph (B) of the preceding sentence, the term 'average rate of interest applicable to life insurance reserves' means the ratio obtained by dividing the sum obtained under paragraph (1) of section 805(c) by the sum obtained under paragraph (1)(B) of section 805(c).

(3) DIVIDENDS RECEIVED DEDUCTION WHERE MAXIMUM LIMIT APPLIES.—

(A) If paragraph (1) of this subsection reduces the reserve and other policy liability deduction allowed by this section or section 812 for the taxable year, then in computing life insurance taxable income under section 802(b), and in computing life insurance company taxable income under section 811(b), there shall be allowed an additional deduction in an amount determined under subparagraph (B).

(B) The amount of the additional deduction referred to in subparagraph (A) shall be the amount which bears the same ratio to the total of the deductions provided in sections 243, 244, and 245 as the net investment income reduced by the sum of—

(i) the net investment income allocable to non-life insurance reserves (or, for purposes of section 811(b), the amount of the adjustment for certain reserves provided in section 813), and

(ii) 100/85 of the maximum limitation determined under paragraphs (1) and (2) of this subsection,

bears to the net investment income.

(c) QUALIFIED RESERVES DEFINED.—For purposes of this subpart, the term "qualified reserves" means the sum of the following:

(1) The life insurance reserves (as defined in section 801 (b)), plus 7 percent of that portion of such reserves as are computed on a preliminary term basis.

(2) The non-life insurance reserves (as defined in subsection (d) (2)).

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance and annuity contracts (including contracts supplementary thereto), but only if (A) such obligations when satisfied will reflect an increment in the nature of interest, and (B) such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, health, or accident contingencies.

(4) The amounts held at the end of the taxable year as reserves for dividends to policy holders, the payment of which dividends is deferred for a period which expires not earlier than 5 years from the date of the policy contract. This paragraph does not apply to dividends payable during the year following the taxable year.

(5) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto).

(6) Premiums received in advance, and liabilities for premium deposit funds.

In appling this subsection the same item shall be counted only once. For purposes of this section (other than paragraph (4) of this subsection), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

(d) NET INVESTMENT INCOME ALLOCABLE TO NON-LIFE INSURANCE RESERVES.—

(1) ALLOCATION RATIO.—For purposes of this subpart, the net investment income allocable to non-life insurance reserves is that amount which bears the same ratio to the net investment income as such reserves bear to the qualified reserves.

(2) NON-LIFE INSURANCE RESERVES DEFINED.—For purposes of this subpart the term "non-life insurance reserves" means the sum of the unearned premiums and the unpaid losses (whether or not ascertained)—

(A) on contracts other than life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance), and

(B) which are not included in life insurance reserves (as defined in section 801 (b)).

For purposes of this paragraph, 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.

(3) ADJUSTMENTS WITH RESPECT TO CERTAIN NON-LIFE INSURANCE CONTRACTS.—For the purposes of this subpart, if—

(A) any computation under this subpart is made by reference to a contract meeting the requirements of paragraph (2) (A) of this subsection, and

(B) part of the reserves for such contract are life insurance reserves, then, under regulations prescribed by the Secretary or his delegate, proper adjustment shall be made in the amount taken into account with respect to such contract for purposes of such computation.

SEC. 805. SPECIAL INTEREST DEDUCTION.

(a) SPECIAL INTEREST DEDUCTION.—For purposes of the tax imposed by section 802 (and the tax imposed by section 811), there shall be allowed a special interest deduction determined as follows:

(1) Divide the amount of the adjusted net investment income (as defined in subsection (b)) by the amount of the required interest (as defined in subsection (c)).

(2) If the quotient obtained in paragraph (1) is 1.05 or more, the special interest deduction shall be zero.

(3) If the quotient obtained in paragraph (1) is 1.00 or less, the special interest deduction shall be an amount equal to 50 percent of the amount by which—

(A) the net investment income (reduced by the net investment income allocable to non-life insurance reserves), exceeds

(B) the reserve and other policy liability deduction for the taxable year.

(4) If the quotient obtained in paragraph (1) is more than 1.00 but less than 1.05, the special interest deduction shall be the amount obtained by multiplying—

(A) the amount by which (i) the net investment income (reduced by the net investment income allocable to non-life insurance reserves) exceeds (ii) the reserve and other policy liability deduction for the taxable year, by

(B) 10 times the difference between the figure 1.05 and the quotient obtained in paragraph (1).

(b) ADJUSTED NET INVESTMENT INCOME.—For purposes of subsection (a)(1), the term "adjusted net investment income" means—

(1) the net investment income (computed without the deduction for wholly-exempt interest allowed by section 803(c)(1)), minus

(2) 50 percent of the net investment income allocable to non-life insurance reserves.

(c) REQUIRED INTEREST.—For purposes of subsection (a)(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 life insurance reserves computed at such rate at the beginning and end of the taxable year, plus 7 percent of the portion of such reserves at such rates as are computed on a preliminary term basis;

(2) the sum of the amounts obtained by multiplying—

(A) each rate of interest assumed in computing the taxpayer's reserves for deferred dividends described in section 804(c)(4), by

(B) the means of the amounts of such reserves computed at such rate at the end of the taxable year; and

(3) interest paid.

(d) INTEREST PAID.—For purposes of subsection (c)(3), 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 on 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.

SUBPART B—1942 FORMULA

Sec. 811. Tax imposed.
Sec. 812. Reserve and other policy liability deduction.
Sec. 813. Adjustment for certain reserves.

SEC. 811. TAX IMPOSED.

(a) TAX IMPOSED.—A tax is hereby imposed, on the life insurance company taxable income of every life insurance company, for each taxable year beginning after December 31, 1955. Such tax shall consist of—

(1) a normal tax on such income computed under section 11(b), and

(2) a surtax on such income computed under section 11(c).

(b) LIFE INSURANCE COMPANY TAXABLE INCOME DEFINED.—For purposes of this subpart, the term "life insurance company taxable income" means the net investment income (as defined in section 803(c))—

(1) minus the reserve and other policy liability deduction allowed by section 812,

(2) minus the special interest deduction, if any, allowed by section 805, and

(3) plus the amount of the adjustment for certain reserves provided in section 813.

For purposes of the normal tax, life insurance company taxable income shall be reduced by the deduction provided in section 242 for partially tax-exempt interest.

(c) RULE FOR COMPUTATION OF SPECIAL INTEREST DEDUCTION.—In computing the special interest deduction under section 805 in the case of any taxable year with respect to which a tax is imposed under this section—

(1) in lieu of the reduction of the net investment income provided in paragraphs (3)(A) and (4)(A) of section 805(a), the net investment income shall be reduced by the amount of the adjustment for certain reserves provided in section 813, and

(2) in lieu of subtracting the amount provided in paragraph (2) of section 805(b), subtract 50 percent of the amount of the adjustment for certain reserves provided in section 813.

SEC. 812. RESERVE AND OTHER POLICY LIABILITY DEDUCTION.

(a) GENERAL RULE.—For purposes of this subpart, the term "reserve and other policy liability deduction" means an amount computed by multiplying the net investment income by a figure, to be determined and proclaimed by the Secretary or his delegate for each taxable year with respect to which a tax is imposed by section 811. 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 net investment incomes (computed without the deduction for wholly-exempt interest allowed by section 803(c)(1) over the adjustment for certain reserves provided in section 813.

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

(1) RESERVES FOR DEFERRED DIVIDENDS.—The term "reserves for deferred dividends" has the same meaning as when used in section 804(c)(4).

(2) INTEREST PAID.—The term "interest paid" has the meaning given to such term by section 805(d).

(3) ADJUSTED RESERVES.—The term "adjusted reserves" means the life insurance reserves (as defined in section 801(b)), plus 7 percent of that portion of such reserves as are computed on a preliminary term basis.

(4) 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.

(c) MAXIMUM DEDUCTION.—The reserve and other policy liability deduction allowed by subsection (a) of this section shall in no case exceed an amount equal to the amount which would be determined under subsection (b) of section 804 if such subsection applied with respect to the taxable year.

SEC. 813. ADJUSTMENT FOR CERTAIN RESERVES.

In the case of a life insurance company writing contracts other than life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance), the term "adjustment for certain reserves" means, for purposes of this subpart, 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 801(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.

SUBPART C—MISCELLANEOUS PROVISIONS

Sec. 816. Foreign life insurance companies.
Sec. 817. Denial of double deductions.
Sec. 818. Certain new insurance companies.

SEC. 816. 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 part but shall be taxable as other foreign corporations.

SEC. 817 DENIAL OF DOUBLE DEDUCTIONS.

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

SEC. 818. CERTAIN NEW INSURANCE COMPANIES.

(a) GENERAL RULE.—If the taxable year begins not more than 9 years after the first day on which the taxpayer was authorized to do business as an insurance company, then—

(1) for purposes of subpart A, the life insurance taxable income shall not exceed (A) the amount of the net gain from operations after dividends to policy holders, reduced by (B) (i) the net investment income allocable to non-life insurance reserves and (ii) the special reduction for dividends received provided by subsection (c); or

(2) for purposes of subpart B, the life insurance company taxable income shall not exceed (A) the amount of the net gain from operations after dividends to policyholders, reduced by (B) the special reduction for dividends received provided by subsection (c).

For purposes of this subsection, the net gain from operations after dividends to policyholders shall be computed in the manner required for purposes of the annual statement approved by the National Convention of Insurance Commissioners, except that no reduction shall be made for any Federal income tax.

(b) LIMITATION.—This section shall not reduce the tax for any taxable year below the amount which (but for this section) would be imposed by section 802 or section 811, as the case may be, computed without the applicable limitation on the reserve and other policy liability deduction contained in section 804(b) or section 812(c).

(c) SPECIAL RULE FOR DIVIDENDS RECEIVED.—The reduction referred to in paragraph (1)(B)(ii) and in paragraph (2)(B) of subsection (a) shall be an amount computed under section 804(b)(3), except that, for purposes of such computation, the maximum limitation referred to in section 804(b)(3)(B)(ii) shall be—

(1) in the case of a taxable year with respect to which tax is imposed by 802, the amount by which (A) the net investment income (reduced by the net investment income allocable to non-life insurance reserves), exceeds (B) the life insurance taxable income (computed without regard to the reduction provided by this subsection); or

(2) in the case of a taxable year with respect to which tax is imposed by section 811, the amount by which (A) the sum of the net investment income and the amount of the adjustment for certain reserves provided in section 813, exceeds (B) the life insurance company taxable income (computed without regard to the reduction provided by this subsection).

SEC. 3. ADJUSTMENTS TO INVESTMENT INCOME OF INSURANCE COMPANIES OTHER THAN LIFE.

(a) MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE).—The following provisions of part II of subchapter L of chapter 1 of the Internal Revenue Code of 1954 are hereby amended as follows:

(1) Paragraph (2) of section 821(a) is amended by striking out "interest, dividends, rents," and inserting in lieu thereof "the items described in section 822(b) (other than paragraph (1)(D) thereof)".

(2) Section 821(c) is amended by striking out "interest, dividends, rents," and inserting in lieu thereof "the items described in section 822(b) (other than paragraph (1)(D) thereof)".

(3) Section 822(b) is amended to read as follows:

(b) GROSS INVESTMENT INCOME.—For purposes of subsection (a), the term "gross investment income" means the sum of the following:

(1) The gross amount of income during the taxable year from—

(A) interest, dividends, rents, and royalties,

(B) the entering into of any lease, mortgage, or other instrument or agreement from which the insurance company derives interest, rents, or royalties.

(C) the alteration or termination of any instrument or agreement described in subparagraph (B), and

(D) 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).

(2) The gross income during the taxable year from any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1)

(4) Paragraph (3) of section 822(c) is amended to read as follows:

(3) REAL ESTATE EXPENSE.—Taxes (as provided in section 164), and other expenses, paid or accrued during the taxable year exclusively on or with respect to the real estate owned by the company. No deductions shall be allowed under this paragraph for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property

(5) Paragraph (6) of section 822(c) is amended by striking out "the sum of interest, dividends, rents, and net premiums received. In the application of section 1211" and inserting in lieu thereof "the sum of the items described in subsection (b) (other than paragraph (1) (D) thereof) and net premiums received. In the application of section 1212".

(6) Section 822(c) is amended by adding at the end thereof the following new paragraphs:

(8) TRADE OR BUSINESS DEDUCTIONS.—The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the insurance company is a partner; except that for purposes of this paragraph—

(A) any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account, and

(B) the deduction for net operating losses provided in section 172 shall not be allowed.

(9) DEPLETION.—The deduction allowed by section 611 (relating to depletion)

(7) Section 822(d)(1) is amended by striking out "subsection (e) (3) or (4)" and inserting in lieu thereof "subsection (c) (3) or (4)".

(8) Section 822(e) is amended by striking out "interest, dividends, rents," and inserting in lieu thereof "items described in subsection (b) (other than paragraph (1) (D) thereof)".

(b) STOCK COMPANIES (OTHER THAN LIFE).—The following provisions of section 832 are hereby amended as follows:

(1) Paragraph (4) of subsection is amended by striking out "section 806" and inserting "section 801(b)".

(2) Paragraph (5) of subsection (c) is amended by striking out "interest, dividends, rents, and net premiums received. In the application of section 1211" and inserting in lieu thereof "the items described in section 822(b) (other than paragraph (1) (D) thereof) and net premiums received. In the application of section 1212".

(3) Paragraph (8) of subsection (c) is amended by inserting after "section 167" the following: "and the deduction allowed by section 611 (relating to depletion)".

SEC. 4 ANNUAL ACCOUNTING PERIOD OF INSURANCE COMPANIES TO BE THE CALENDAR YEAR.

(a) Part IV of subchapter L of chapter 1 of the Internal Revenue Code of 1954 (relating to provisions of general application with respect to insurance companies) is hereby amended by adding at the end thereof the following new section:

SEC. 843. ANNUAL ACCOUNTING PERIOD.

For purposes of this subtitle, the annual accounting period for each insurance company subject to a tax imposed by this subchapter shall be the calendar year.

(b) The table of sections for such part IV is hereby amended by adding at the end thereof the following:

Sec. 843. Annual accounting period.

SEC. 5. TECHNICAL AMENDMENTS.

The following provisions of the Internal Revenue Code of 1954 are hereby amended as follows:

(1) Section 316(b)(1) (relating to definition of dividends) is amended to read as follows:

(1) CERTAIN INSURANCE COMPANY DIVIDENDS.—The definition in subsection (a) shall not apply to the term "dividend" as used in subchapter L in any case where the reference is to dividends of insurance companies paid to policyholders as such.

(2) Section 501(c)(15) (relating to certain exempt mutual insurance companies) is amended by striking out "interest, dividends, rents," and inserting in lieu thereof "the items described in section 822(b) (other than paragraph (1)(D) thereof)".

(3) Section 594(a)(2) is amended by striking out "the taxable income (as defined in section 803)" and inserting in lieu thereof "the income".

(4) The first sentence of section 841 (relating to credit for foreign taxes) is amended by inserting "811," after "802,". Paragraph (1) of the second sentence of such section is amended to read as follows:

(1) in the case of the tax imposed by section 802 or 811, the net investment income (as defined in section 803(c)),

(5) Section 842 (relating to computation of gross income) is amended by striking out "802 or 831" and inserting in lieu thereof "802, 811, or 831".

(6) Section 891 (relating to doubling of rates of tax in case of discrimination by a foreign country) is amended by inserting "811," after "802,".

(7) Section 1201(a) (relating to alternative tax on capital gains) is amended by inserting "802(a)," after "511,".

(8) Section 1504(b)(2) (relating to exceptions from consolidated return provisions) is amended by striking out "802 or 821" and inserting in lieu thereof "802, 811, or 821".

(9) Paragraph (2) of section 4371 (relating to tax on policies issued by foreign insurers) is amended by striking out "807" and inserting in lieu thereof "816".

SEC. 6. EFFECTIVE DATE.

The amendments made by this Act shall apply only to taxable years beginning after December 31, 1954.

SEC. 7. SAVINGS PROVISIONS.

In the case of any taxpayer subject to tax under section 802 or 807 of the Internal Revenue Code of 1954 (as such sections were in effect before the enactment of this Act), no addition to the tax shall be made under section 6655 of such Code (relating to failure by corporation to pay estimated tax) with respect to estimated tax for a taxable year beginning in 1955. In the case of any taxpayer subject to tax under section 821 of such Code (imposing a tax on certain mutual insurance companies), any addition to the tax under section 6655 of such Code with respect to estimated tax for a taxable year beginning in 1955 shall in no case be larger than such addition would have been if this Act had not been enacted.

Approved March 13, 1956.

PUBLIC LAW 458, EIGHTY-FOURTH CONGRESS
[CHAPTER 115, SECOND SESSION]
H. R. 9166 [10]

An Act to provide a one-year extension of the existing corporate normal-tax rate and of certain excise-tax rates.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Tax Rate Extension Act of 1956".

SEC. 2. ONE-YEAR EXTENSION OF CORPORATE NORMAL-TAX RATE.

Section 11(b) (relating to corporate normal tax), section 821(a)(1)(A) (relating to mutual insurance companies other than interinsurers), and section 821(b)(1) (relating to interinsurers) of the Internal Revenue Code of 1954 are amended as follows:

(1) By striking out "APRIL 1, 1956" each place it appears and inserting in lieu thereof "APRIL 1, 1957";

(2) By striking out "April 1, 1956" each place it appears and inserting in lieu thereof "April 1, 1957";

(3) By striking out "MARCH 31, 1956" each place it appears and inserting in lieu thereof "MARCH 31, 1957";

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[10] House Report No. 1860, page 997 this Bulletin; Senate Report No. 1710, page 1000 this Bulletin.

(4) By striking out "March 31, 1956" each place it appears and inserting in lieu thereof "March 31, 1957".

SEC. 3. ONE-YEAR EXTENSION OF CERTAIN EXCISE TAX RATES.

(a) EXTENSION OF RATES.—The following provisions of the Internal Revenue Code of 1954 are amended by striking out "April 1, 1956" each place it appears and inserting in lieu thereof "April 1, 1957"—

(1) Section 4041(c) (relating to special fuels);
(2) section 4061 (relating to motor vehicles);
(3) section 4081 (relating to gasoline);
(4) section 5001(a)(1) (relating to distilled spirits);
(5) section 5001(a)(3) (relating to imported perfumes containing distilled spirits);
(6) section 5022 (relating to cordials and liqueurs containing wine);
(7) section 5041(b) (relating to wines);
(8) section 5051(a) (relating to beer); and
(9) section 5701(c)(1) (relating to cigarettes).

(b) TECHNICAL AMENDMENTS.—The following provisions of the Internal Revenue Code of 1954 are amended as follows:

(1) Section 5063 (relating to floor stocks refunds on distilled spirits, wines, cordials, and beer) is amended by striking out "April 1, 1956" each place it appears and inserting in lieu thereof "April 1, 1957", and by striking out "May 1, 1956" and inserting in lieu thereof "May 1, 1957".

(2) Section 5134(a)(3) (relating to drawback in the case of distilled spirits) is amended by striking out "March 31, 1956" and inserting in lieu thereof "March 31, 1957".

(3) Subsections (a) and (b) of section 5707 (relating to floor stocks refunds on cigarettes) are amended by striking out "April 1, 1956" each place it appears and inserting in lieu thereof "April 1, 1957", and by striking out "July 1, 1956" and inserting in lieu thereof "July 1, 1957".

(4) Subsections (a) and (b) of section 6412 (relating to floor stocks refunds on motor vehicles and gasoline) are amended by striking out "April 1, 1956" each place it appears and inserting in lieu thereof "April 1, 1957", and by striking out "July 1, 1956" each place it appears and inserting in lieu thereof "July 1, 1957".

Section 497 of the Revenue Act of 1951 (relating to refunds on articles from foreign trade zones), as amended, is amended by striking out "April 1, 1956" each place it appears and inserting in lieu thereof "April 1, 1957".

Approved March 29, 1956.

PUBLIC LAW 466, EIGHTY-FOURTH CONGRESS
[CHAPTER 160, SECOND SESSION]
H. R. 8780 [11]

An Act to amend the Internal Revenue Code of 1954 to relieve farmers from excise taxes in the case of gasoline and special fuels used on the farm for farming purposes.

[11] House Report No. 1684, page 983 this Bulletin; Senate Report No. 1609, page 989 this Bulletin; House Conference Report No. 1957, page 995 this Bulletin.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. RELIEF FROM EXCISE TAX ON GASOLINE.

Subchapter B of chapter 65 of the Internal Revenue Code of 1954 (rules of special application for abatements, credits, and refunds) is amended by renumbering section 6420 as 6421 and by inserting after section 6419 the following new section:

SEC. 6420. GASOLINE USED ON FARMS.

(a) GASOLINE.—If gasoline is used on a farm for farming purposes, the Secretary or his delegate shall pay (without interest) to the ultimate purchaser of such gasoline the amount determined by multiplying—

(1) the number of gallons so used, by

(2) the rate of tax on gasoline under section 4081 which applied on the date he purchased such gasoline.

(b) TIME FOR FILING CLAIM; PERIOD COVERED.—Not more than one claim may be filed under this section by any person with respect to gasoline used during the one-year period ending on June 30 of any year. No claim shall be allowed under this section with respect to any one-year period unless filed on or before September 30 of the year in which such one-year period ends.

(c) MEANING OF TERMS.—For purposes of this section—

(1) USE ON A FARM FOR FARMING PURPOSES.—Gasoline shall be treated as used on a farm for farming purposes only if used (A) in carrying on a trade or business, (B) on a farm situated in the United States, and (C) for farming purposes.

(2) FARM.—The term "farm" includes stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards.

(3) FARMING PURPOSES.—Gasoline shall be treated as used for farming purposes only if used—

(A) by the owner, tenant, or operator of a farm, in connection with cultivating the soil, or in connection with raising or harvesting any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and mangagement of livestock, bees, poultry, and fur-bearing animals and wildlife, on a farm of which he is the owner, tenant, or operator; except that if such use is by any person other than the owner, tenant, or operator of such farm, then (i) for purposes of this subparagraph, in applying subsection (a) to this subparagraph, and for purposes of section 6416(b)(2)(C)(ii) (but not for purposes of section 4041), the owner, tenant, or operator of the farm on which gasoline or a liquid taxable under section 4041 is used shall be treated as the user and ultimate purchaser of such gasoline or liquid, and (ii) for purposes of applying section 6416(b)(2)(C)(ii), any tax paid under section 4041 in respect of a liquid used on a farm for farming purposes (within the meaning of this subparagraph) shall be treated as having been paid by the owner, tenant, or operator of the farm on which such liquid is used;

(B) by the owner, tenant, or operator of a farm, in handling, drying, packing, grading, or storing any agricultural or horticultural commodity in its unmanufactured state; but only if such owner, tenant, or operator produced more than one-half of the commodity which he so treated during the period with respect to which claim is filed;

(C) by the owner, tenant, or operator of a farm, in connection with—

(i) the planting, cultivating, caring for, or cutting of trees, or

(ii) the preparation (other than milling) of trees for market,

incidental to farming operations; or

(D) by the owner, tenant, or operator of a farm, in connection with the operation, management, conservation, improvement, or maintenance of such farm and its tools and equipment.

(4) GASOLINE.—The term "gasoline" has the meaning given to such term by section 4082(b).

(d) EXEMPT SALES; OTHER PAYMENTS OR REFUNDS AVAILABLE.—No amount shall be paid under this section with respect to any gasoline which the Secretary or his delegate determines was exempt from the tax imposed by section 4081. The amount which (but for this sentence) would be payable under this section with respect to any gasoline shall be reduced by any other amount which the Secretary or his delegate determines is payable under this section, or is refundable under any provision of this title, to any person with respect to such gasoline.

(e) APPLICABLE LAWS.—

(1) IN GENERAL.—All provisions of law, including penalties, applicable in respect of the tax imposed by section 4081 shall, insofar as applicable and not inconsistent with this section, apply in respect of the payments provided for in this section to the same extent as if such payments constituted refunds of overpayments of the tax so imposed.

(2) EXAMINATION OF BOOKS AND WITNESSES.—For the purpose of ascertaining the correctness of any claim made under this section, or the correctness of any payment made in respect of any such claim, the Secretary or his delegate shall have the authority granted by paragraphs (1), (2), and (3) of section 7602 (relating to examination of books and witnesses) as if the claimant were the person liable for tax.

(3) FRACTIONAL PARTS OF A DOLLAR.—Section 7504 (granting the Secretary discretion with respect to fractional parts of a dollar) shall not apply.

(f) REGULATIONS.—The Secretary or his delegate may by regulations prescribe the conditions, not inconsistent with the provisions of this section, under which payments may be made under this section.

(g) EFFECTIVE DATE.—This section shall apply only with respect to gasoline purchased after December 31, 1955.

(h) CROSS REFERENCES.—

(1) For exemption from tax in case of diesel fuel and special motor fuels used on a farm for farming purposes, see section 4041 (d).
(2) For civil penalty for excessive claim under this section, see section 6675.
(3) For fraud penalties, etc. see chapter 75 (section 7201 and following, relating to crimes, other offenses, and forfeitures).

SEC. 2. RELIEF FROM TAXES ON DIESEL FUEL AND SPECIAL MOTOR FUELS.

(a) (1) Section 4041 of the Internal Revenue Code of 1954 (relating to excise taxes on diesel fuel and special motor fuels) is amended by adding at the end thereof the following new subsection:

(d) EXEMPTION FOR FARM USE.

(1) EXEMPTION.—Under regulations prescribed by the Secretary or his delegate—

(A) no tax shall be imposed under subsection (a) (1) or (b) (1) on the sale of any liquid sold for use on a farm for farming purposes, and
(B) no tax shall be imposed under subsection (a) (2) or (b) (2) on the use of any liquid used on a farm for farming purposes.

(2) USE ON A FARM FOR FARMING PURPOSES.—For purposes of paragraph (1) of this subsection, use on a farm for farming purposes shall be determined in accordance with paragraphs (1), (2), and (3) of section 6420(c).

(2) The amendment made by paragraph (1) shall take effect on the day after the date of the enactment of this Act.

(b) (1) Section 6416(b) (2) (C) of such Code (relating to credit or refund of overpayment of tax on special fuels) is amended to read as follows:

(C) In the case of a liquid taxable under section 4041, sold for use as fuel in a diesel-powered highway vehicle or as fuel for the propulsion of a motor vehicle, motorboat, or airplane, if (i) the vendee used such liquid otherwise than as fuel in such a vehicle, motorboat, or airplane or resold such liquid, or (ii) such liquid was (within the meaning of paragraphs (1), (2), and (3) of section 6420(c)) used on a farm for farming purposes;"

(2) The amendment made by paragraph (1) shall apply with respect to liquid sold after December 31, 1955.

SEC. 3. CIVIL PENALTY FOR EXCESSIVE CLAIMS FOR GASOLINE USED ON FARMS.

Subchapter B of chapter 68 of the Internal Revenue Code of 1954 (relating to assessable penalties) is amended by adding at the end thereof the following new section:

SEC. 6675. EXCESSIVE CLAIMS FOR GASOLINE USED ON FARMS.

(a) CIVIL PENALTY.—In addition to any criminal penalty provided by law, if a claim is made under section 6420 (relating to gasoline used on farms) for an excessive amount, unless it is shown that the claim for such excessive amount is due to reasonable cause, the person making such claim shall be liable to a penalty in an amount equal to whichever of the following is the greater:

(1) Two times the excessive amount; or
(2) $10.

(b) EXCESSIVE AMOUNT DEFINED.—For purposes of this section, the term "excessive amount" means in the case of any person the amount by which—

(1) the amount claimed under section 6420 for any period, exceeds
(2) the amount allowable under such section for such period.

(c) ASSESSMENT AND COLLECTION OF PENALTY.—

For assessment and collection of penalty provided by subsection (a), see section 6206.

SEC. 4. TECHNICAL AMENDMENTS.

(a)(1) Subpart A of part III of subchapter A of chapter 32 of the Internal Revenue Code of 1954 (relating to excise tax on gasoline) is amended by adding at the end thereof the following new section:

SEC. 4084. RELIEF OF FARMERS FROM TAX IN CASE OF GASOLINE USED ON THE FARM.

For provisions to relieve farmers from excise tax in the case of gasoline used on the farm for farming purposes, see section 6420.

(2) The table of sections for such subpart A is amended by adding at the end thereof the following:

Sec. 4084. Relief of farmers from tax in case of gasoline used on the farm.

(b)(1) Subchapter A of chapter 63 of such Code (relating to assessment) is amended by renumbering section 6206 as 6207 and by inserting after section 6205 the following new section:

SEC. 6206. SPECIAL RULES APPLICABLE TO EXCESSIVE CLAIMS UNDER SECTION 6420.

"Any portion of a payment made under section 6420 which constitutes an excessive amount (as defined in section 6675(b)), and any civil penalty provided by section 6675, may be assessed and collected as if it were a tax imposed by section 4081 and as if the person who made the claim were liable for such tax. The period for assessing any such portion, and for assessing any such penalty, shall be 3 years from the last day prescribed for the filing of the claim under section 6420.

(2) The table of sections for such subchapter A is amended by striking out

Sec. 6206. Cross references.

and inserting in lieu thereof

Sec. 6206. Special rules applicable to excessive claims under section 6420.
Sec. 6207. Cross references.

(c) The table of sections for subchapter B of chapter 65 of such Code is amended by striking out

Sec. 6420. Cross references.

and inserting in lieu thereof the following:

Sec. 6420. Gasoline used on farms.
Sec. 6421. Cross references.

(d) Section 6504 of such Code (cross references for limitations on assessments) is amended by adding at the end thereof the following:

(13) Assessments to recover excessive amounts paid under section 6420 (relating to gasoline used on farms) and assessments of civil penalties under section 6675 for excessive claims under section 6420, see section 6206.

(e) Section 6511(f) of such Code (cross references for limitations on credit or refund) is amended by adding at the end thereof the following:

(5) For limitations in case of payments under section 6420 (relating to gasoline used on farms), see section 6420(b).

(f) Section 6612(c) of such Code (cross references for restrictions on interest) is amended by striking out **"and"** before **"6519"** and by inserting before the period at the end thereof the following: **", and 6420 (relating to payments in the case of gasoline used on the farm for farming purposes)".**

(g) The table of sections for subchapter B of chapter 68 of such Code is amended by adding at the end thereof the following:

Sec. 6675. Excessive claims for gasoline used on farms.

(h) Section 7210 of such Code (relating to failure to obey summons) is amended by striking out "sections 7602," and inserting in lieu thereof "sections 6420(e)(2), 7602,".

(i) Sections 7603 (relating to service summons) and 7604 (relating to enforcement of summons) and the first sentence of section 7605 (relating to time and place of examination) of such Code are each amended by striking out "section 7602" wherever it appears and inserting in lieu thereof "section 6420(e)(2) or 7602". The second sentence of section 7605 of such Code is amended by striking out "section 7602" and inserting in lieu thereof "section 7602, or under the corresponding authority of section 6420(e)(2),".

Approved April 2, 1956.

PUBLIC LAW 495, EIGHTY-FOURTH CONGRESS
[CHAPTER 214, SECOND SESSION]
H. R. 6712 [12]

An Act to amend section 1237 of the Internal Revenue Code of 1954.

Be it enacted by the Senate and House of Representatives of the United States of American in Congress assembled, That section 1237 (a) of the Internal Revenue Code of 1954 is amended by striking out "other than a corporation" and inserting: "(including corporations only if no shareholder directly or indirectly holds real property for sale to customers in the ordinary course of trade or business and only in the case of property described in the last sentence of subsection (b)(3))".

SEC. 2. Section 1237(b)(3) of the Internal Revenue Code of 1954 is amended as follows:

(a) In subparagraph (A) strike out "water or sewer facilities" and insert: "water, sewer, or drainage facilities".

(b) At the end of paragraph (3) insert "The requirements of subparagraphs (B) and (C) shall not apply in the case of prop-

[12] House Report No. 1608, poge 938 this Bulletin; Senate Report No. 1705, page 939 this Bulletin.

erty acquired through the foreclosure of a lien thereon which secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of its stock and other consideration and in the case of property adjacent to such property if 80 percent of the real property owned by the taxpayer is property described in the first part of this sentence.".

SEC. 3. This Act shall apply to all taxable years beginning after December 31, 1954.

Approved April 27, 1956.

PUBLIC LAW 511, EIGHTY-FOURTH CONGRESS
[CHAPTER 240, SECOND SESSION]
H. R. 6227 [13]

An Act to define bank holding companies, control their future expansion, and require divestment of their non-banking interests.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled. That this Act may be cited as the "Bank Holding Company Act of 1956."

DEFINITIONS

SEC. 2. (a) "Bank holding company" means any company (1) which directly or indirectly owns, controls, or holds with power to vote, 25 per centum or more of the voting shares of each of two or more banks or of a company which is or becomes a bank holding company by virtue of this Act, or (2) which controls in any manner the election of a majority of the directors of each of two or more banks, or (3) for the benefit of whose shareholders or members 25 per centum or more of the voting shares of each of two or more banks or a bank holding company is held by trustees; and for the purposes of this Act, any successor to any such company shall be deemed to be a bank holding company from the date as of which such predecessor company became a bank holding company. Notwithstanding the foregoing (A) no bank shall be a bank holding company by virtue of its ownership or control of shares in a fiduciary capacity, except where such shares are held for the benefit of the shareholders of such bank, (B) no company shall be a bank holding company which is registered under the Investment Company Act of 1940, and was so registered prior to May 15, 1955 (or which is affiliated with any such company in such manner as to constitute an affiliated company within the meaning of such Act), unless such company (or such affiliated company), as the case may be, directly owns 25 per centum or more of the voting shares of each of two or more banks, (C) no company shall be a bank holding company by virtue of its ownership or control of shares acquired by it in connection with its underwriting of securities and which are held only for such period of time as will permit the sale thereof upon a reasonable basis, (D) no company formed for the sole purpose of participating in a proxy solicitation shall be a bank holding company by virtue of

[13] House Report No. 609, page 927 this Bulletin; Senate Report No. 1095, page 893 this Bulletin; Senate Report No. 1095, Part 2, page 907 this Bulletin.

its control of voting rights of shares acquired in the course of such solicitation, and (E) no company shall be a bank holding company if at least 80 per centum of its total assets are composed of holdings in the field of agriculture.

(b) "Company" means any corporation, business trust, association, or similar organization, but shall not include (1) any corporation the majority of the shares of which are owned by the United States or by any State, or (2) any corporation or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, or (3) any partnership.

(c) "Bank" means any national banking association or any State bank, savings bank, or trust company, but shall not include any organization operating under section 25(a) of the Federal Reserve Act, or any organization which does not do business within the United States. "State member bank" means any State bank which is a member of the Federal Reserve System. "District bank" means any State bank organized or operating under the Code of Law for the District of Columbia.

(d) "Subsidiary", with respect to a specified bank holding company, means (1) any company 25 per centum or more of whose voting shares (excluding shares owned by the United States or by any company wholly owned by the United States) is owned or controlled by such bank holding company; or (2) any company the election of a majority of whose directors is controlled in any manner by such bank holding company; or (3) any company 25 per centum or more of whose voting shares are held by trustees for the benefit of the shareholders or members of such bank holding company.

(e) The term "successor" shall include any company which acquires directly or indirectly from a bank holding company shares of any bank, when and if the relationship between such company and the bank holding company is such that the transaction effects no substantial change in the control of the bank or beneficial ownership of such shares of such bank. The Board may, by regulation, further define the term "successor" to the extent necessary to prevent evasion of the purposes of this Act.

(f) "Board" means the Board of Governors of the Federal Reserve System.

(g) "Agriculture", as used in section 2 (a), includes farming in all its branches including fruitgrowing, dairying, the raising of livestock, bees, fur-bearing animals, or poultry, forestry or lumbering operations, and the production of naval stores, and operations directly related thereto.

ACQUISITION OF BANK SHARES OR ASSETS

SEC. 3. (a) It shall be unlawful except with the prior approval of the Board (1) for any action to be taken which results in a company becoming a bank holding company under section 2 (a) of this Act; (2) for any bank holding company to acquire direct or indirect ownership or control of any voting shares of any bank if, after such

acquisition, such company will directly or indirectly own or control more than 5 per centum of the voting shares of such bank; (3) for any bank holding company or subsidiary thereof, other than a bank, to acquire all or substantially all of the assets of a bank; or (4) for any bank holding company to merge or consolidate with any other bank holding company. Notwithstanding the foregoing this prohibition shall not apply to (A) shares acquired by a bank, (i) in good faith in a fiduciary capacity, except where such shares are held for the benefit of the shareholders of such bank, or (ii) in the regular course of securing or collecting a debt previously contracted in good faith, but any shares acquired after the date of enactment of this Act in securing or collecting any such previously contracted debt shall be disposed of within a period of two years from the date on which they were acquired; or (B) additional shares acquired by a bank holding company in a bank in which such bank holding company owned or controlled a majority of the voting shares prior to such acquisition.

(b) Upon receiving from a company any application for approval under this section, the Board shall give notice to the Comptroller of the Currency, if the applicant company or any bank the voting shares or assets of which are sought to be acquired is a national banking association or a District bank, or to the appropriate supervisory authority of the interested State, if the applicant company or any bank the voting shares or assets of which are sought to be acquired is a State bank, and shall allow thirty days within which the views and recommendations of the Comptroller of the Currency or the State supervisory authority, as the case may be, may be submitted. If the Comptroller of the Currency or the State supervisory authority so notified by the Board disapproves the application in writing within said thirty days, the Board shall forthwith give written notice of that fact to the applicant. Within three days after giving such notice to the applicant, the Board shall notify in writing the applicant and the disapproving authority of the date for commencement of a hearing by it on such application. Any such hearing shall be commenced not less than ten nor more than thirty days after the Board has given written notice to the applicant of the action of the disapproving authority. The length of any such hearing shall be determined by the Board, but it shall afford all interested parties a reasonable opportunity to testify at such hearing. At the conclusion thereof, the Board shall by order grant or deny the application on the basis of the record made at such hearing.

(c) In determining whether or not to approve any acquisition or merger or consolidation under this section, the Board shall take into consideration the following factors: (1) the financial history and condition of the company or companies and the banks concerned; (2) their prospects; (3) the character of their management; (4) the convenience, needs and welfare of the communities and the area concerned; and (5) whether or not the effect of such acquisition or merger or consolidation would be to expand the size or extent of the bank holding company system involved beyond limits consistent with adequate and sound banking, the public interest, and the preservation of competition in the field of banking.

(d) Notwithstanding any other provision of this section, no application shall be approved under this section which will permit any bank holding company or any subsidiary thereof to acquire, directly

or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional bank located outside of the State in which such bank holding company maintains its principal office and place of business or in which it conducts its principal operations unless the acquisition of such shares or assets of a State bank by an out-of-State bank holding company is specifically authorized by the statute laws of the State in which such bank is located, by language to that effect and not merely by implication.

INTERESTS IN NONBANKING ORGANIZATIONS

SEC. 4. (a) Except as otherwise provided in this Act, no bank holding company shall—

(1) after the date of enactment of this Act acquire direct or indirect ownership or control of any voting shares of any company which is not a bank, or

(2) after two years from the date of enactment of this Act or from the date as of which it becomes a bank holding company, whichever is later, retain direct or indirect ownership or control of any voting shares of any company which is not a bank or a bank holding company or engage in any business other than that of banking or of managing or controlling banks or of furnishing services to or performing services for any bank of which it owns or controls 25 per centum or more of the voting shares.

The Board is authorized, upon application by a bank holding company, to extend the period referred to in paragraph (2) above from time to time as to such bank holding company for not more than one year at a time if, in its judgment, such an extension would not be detrimental to the public interest, but no such extensions shall extend beyond a date five years after the date of enactment of this Act or five years after the date as of which a company becomes a bank holding company, whichever is later.

(b) After two years from the date of enactment of this Act, no certificate evidencing shares of any bank holding company shall bear any statement purporting to represent shares of any other company except a bank or a bank holding company, nor shall the ownership, sale, or transfer of shares of any bank holding company be conditioned in any manner whatsoever upon the ownership, sale, or transfer of shares of any other company except a bank or a bank holding company.

(c) The prohibitions in this section shall not apply—

(1) to shares owned or acquired by a bank holding company in any company engaged solely in holding or operating properties used wholly or substantially by any bank with respect to which it is a bank holding company in its operations or acquired for such future use or engaged solely in conducting a safe deposit business, or solely in the business of furnishing services to or performing services for such holding company and banks with respect to which it is a bank holding company, or in liquidating assets acquired from such bank holding company and such banks;

(2) to shares acquired by a bank holding company which is a bank, or by any banking subsidiary of a bank holding company, in satisfaction of a debt previously contracted in good faith, but such bank holding company or such subsidiaries shall dispose of such shares within a period of two years from the date on which

they were acquired or from the date of enactment of this Act, whichever is later;

(3) to shares acquired by a bank holding company from any of its subsidiaries which subsidiary has been requested to dispose of such shares by any Federal or State authority having statutory power to examine such subsidiary, but such bank holding company shall dispose of such shares within a period of two years from the date on which they were acquired or from the date of enactment of this Act, whichever is later;

(4) to shares which are held or acquired by a bank holding company which is a bank or by any banking subsidiary of a bank holding company, in good faith in a fiduciary capacity, except where such shares are held for the benefit of the shareholders of such bank holding company or any of its subsidiaries, or to shares which are of the kinds and amounts eligible for investment by National banking associations under the provisions of section 5136 of the Revised Statutes, or to shares lawfully acquired and owned prior to the date of enactment of this Act by a bank which is a bank holding company, or by any of its wholly owned subsidiaries;

(5) to shares of any company which are held or acquired by a bank holding company which do not include more than 5 per centum of the outstanding voting securities of such company, and do not have a value greater than 5 per centum of the value of the total assets of the bank holding company, or to the ownership by a bank holding company of shares, securities, or obligations of an investment company which is not a bank holding company and which is not engaged in any business other than investing in securities, which securities do not include more than 5 per centum of the outstanding voting securities of any company and do not include any single asset having a value greater than 5 per centum of the value of the total assets of the bank holding company;

(6) to shares of any company all the activities of which are of a financial, fiduciary, or insurance nature and which the Board after due notice and hearing, and on the basis of the record made at such hearing, by order has determined to be so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto and as to make it unnecessary for the prohibitions of this section to apply in order to carry out the purposes of this Act;

(7) to any bank holding company which is a labor, agricultural, or horticultural organization and which is exempt from taxation under section 501 of the Internal Revenue Code of 1954; or

(8) to shares held or acquired by a bank holding company in any company which is organized under the laws of a foreign country and which is engaged principally in the banking business outside the United States.

ADMINISTRATION

SEC. 5. (a) Within one hundred and eighty days after the date of enactment of this Act, or within one hundred and eighty days after

becoming a bank holding company, whichever is later, each bank holding company shall register with the Board on forms prescribed by the Board, which shall include such information with respect to the financial condition and operations, management, and intercompany relationships of the bank holding company and its subsidiaries, and related matters, as the Board may deem necessary or appropriate to carry out the purposes of this Act. The Board may, in its discretion, extend the time within which a bank holding company shall register and file the requisite information.

(b) The Board is authorized to issue such regulations and orders as may be necessary to enable it to administer and carry out the purposes of this Act and prevent evasions thereof.

(c) The Board from time to time may require reports under oath to keep it informed as to whether the provisions of this Act and such regulations and orders issued thereunder have been complied with; and the Board may make examinations of each bank holding company and each subsidiary thereof, the cost of which shall be assessed against, and paid by, such holding company. The Board shall, as far as possible, use the reports of examinations made by the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the appropriate State bank supervisory authority for the purposes of this section.

(d) Before the expiration of two years following the date of enactment of this Act, and each year thereafter in the Board's annual report to the Congress, the Board shall report to the Congress the results of the administration of this Act, stating what, if any, substantial difficulties have been encountered in carrying out the purposes of this Act, and any recommendations as to changes in the law which in the opinion of the Board would be desirable.

BORROWING BY BANK HOLDING COMPANY OR ITS SUBSIDIARIES

SEC. 6. (a) From and after the date of enactment of this Act, it shall be unlawful for a bank—

(1) to invest any of its funds in the capital stock, bonds, debentures, or other obligations of a bank holding company of which it is a subsidiary, or of any other subsidiary of such bank holding company;

(2) to accept the capital stock, bonds, debentures, or other obligations of a bank holding company of which it is a subsidiary or any other subsidiary of such bank holding company, as collateral security for advances made to any person or company: *Provided, however*, That any bank may accept such capital stock, bonds, debentures, or other obligations as security for debts previously contracted, but such collateral shall not be held for a period of over two years;

(3) to purchase securities, other assets or obligations under repurchase agreement from a bank holding company of which it is a subsidiary or any other subsidiary of such bank holding company; and

(4) to make any loan, discount or extension of credit to a bank holding company of which it is a subsidiary or to any other subsidiary of such bank holding company.

Non-interest-bearing deposits to the credit of a bank shall not be deemed to be a loan or advance to the bank of deposit, nor shall the giving of immediate credit to a bank upon uncollected items received in the ordinary course of business be deemed to be a loan or advance to the depositing bank.

(b) The provisions of this section shall not apply (1) to the capital stock, bonds, debentures, or other obligations of any company described in section 4(c)(1) of this Act, or (2) to any company whose subsidiary status has arisen out of a bona fide debt to the bank contracted prior to the date of the creation of such status, or (3) to any company whose subsidiary status exists by reason of the ownership or control of voting shares thereof by the bank as executor, administrator, trustee, receiver, agent, or depositary, or in any other fiduciary capacity, except where such shares are held for the benefit of all or a majority of the stockholders of such bank.

RESERVATION OF RIGHTS TO STATES

SEC. 7. The enactment by the Congress of the Bank Holding Company Act of 1956 shall not be construed as preventing any State from exercising such powers and jurisdiction which it now has or may hereafter have with respect to banks, bank holding companies, and subsidiaries thereof.

PENALTIES

SEC. 8. Any company which willfully violates any provision of this Act, or any regulation or order issued by the Board pursuant thereto, shall upon conviction be fined not more than $1,000 for each day during which the violation continues. Any individual who willfully participates in a violation of any provision of this Act shall upon conviction be fined not more than $10,000 or imprisoned not more than one year, or both. Every officer, director, agent, and employee of a bank holding company shall be subject to the same penalties for false entries in any book, report, or statement of such bank holding company as are applicable to officers, directors, agents, and employees of member banks for false entries in any books, reports, or statements of member banks under section 1005 of title 18, United States Code.

JUDICIAL REVIEW

SEC. 9. Any party aggrieved by an order of the Board under this Act may obtain a review of such order in the United States Court of Appeals within any circuit wherein such party has its principal place of business, or in the Court of Appeals in the District of Columbia, by filing in the court, within sixty days after the entry of the Board's order, a petition praying that the order of the Board be set aside. A copy of such petition shall be forthwith served upon the Board, and thereupon the Board shall certify and file in the court a transcript of the record made before the Board. Upon the filing of the transcript the court shall have jurisdiction to affirm, set aside, or modify the order of the Board and to require the Board to take such action with regard to the matter under review as the court deems proper. The findings of the Board as to the facts, if supported by substantial evidence, shall be conclusive.

AMENDMENTS TO INTERNAL REVENUE CODE OF 1954

SEC. 10. (a) Subchapter O of chapter 1 of the Internal Revenue Code of 1954 is amended by adding at the end thereof the following new part:

PART VIII.—DISTRIBUTIONS PURSUANT TO BANK HOLDING COMPANY ACT OF 1956

"Sec. 1101. Distributions pursuant to Bank Holding Company Act of 1956.
"Sec. 1102. Special rules.
"Sec. 1103. Definitions.

SEC. 1101. DISTRIBUTIONS PURSUANT TO BANK HOLDING COMPANY ACT OF 1956.

(a) DISTRIBUTIONS OF CERTAIN NON-BANKING PROPERTY.—

(1) DISTRIBUTIONS OF PROHIBITED PROPERTY.—IF—

(A) a qualified bank holding corporation distributes prohibited property (other than stock received in an exchange to which subsection (c) (2) applies)—

(i) to a shareholder (with respect to its stock held by such shareholder), without the surrender by such shareholder of stock in such corporation; or

(ii) to a shareholder, in exchange for its preferred stock; or

(iii) to a security holder, in exchange for its securities; and

(B) the Board has, before the distribution, certified that the distribution of such prohibited property is necessary or appropriate to effectuate section 4 of the Bank Holding Company Act of 1956.

then no gain to the shareholder or security holder from the receipt of such property shall be recognized.

(2) DISTRIBUTIONS OF STOCK AND SECURITIES RECEIVED IN AN EXCHANGE TO WHICH SUBSECTION (c) (2) APPLIES.—IF—

(A) a qualified bank holding corporation distributes—

(i) common stock received in an exchange to which subsection (c) (2) applies to a shareholder (with respect to its stock held by such shareholder), without the surrender by such shareholder of stock in such corporation; or

(ii) common stock received in an exchange to which subsection (c) (2) applies to a shareholder, in exchange for its common stock; or

(iii) preferred stock or common stock received in an exchange to which subsection (c) (2) applies to a shareholder, in exchange for its preferred stock; or

(iv) securities or preferred or common stock received in an exchange to which subsection (c) (2) applies to a security holder, in exchange for its securities; and

(B) any preferred stock received has substantially the same terms as the preferred stock exchanged, and any securities received have substantially the same terms as the securities exchanged,

then, except as provided in subsection (f), no gain to the shareholder or security holder from the receipt of such stock or such securities or such stock and securities shall be recognized.

(3) NON PRO RATA DISTRIBUTIONS.—Paragraphs (1) and (2) shall apply to a distribution whether or not the distribution is pro rata with respect to all of the shareholders of the distributing qualified bank holding corporation.

(4) EXCEPTION.—This subsection shall not apply to any distribution by a corporation which has made any distribution pursuant to subsection (b).

(5) DISTRIBUTIONS INVOLVING GIFT OR COMPENSATION.—

In the case of a distribution to which paragraph (1) or (2) applies but which—
(A) results in a gift, see section 2501, and following, or
(B) has the effect of the payment of compensation, see section 61(a)(1).

(b) CORPORATION CEASING TO BE A BANK HOLDING COMPANY.—

(1) DISTRIBUTIONS OF PROPERTY WHICH CAUSE A CORPORATION TO BE A BANK HOLDING COMPANY.—If—

(A) a qualified bank holding corporation distributes property (other than stock received in an exchange to which subsection (c) (3) aplies)—

(i) to a shareholder (with respect to its stock held by such shareholder), without the surrender by such shareholder of stock in such corporation; or

(ii) to a shareholder, in exchange for its preferred stock; or
(iii) to a security holder, in exchange for its securities; and

(B) the Board has, before the distribution, certified that—
(i) such property is all or part of the property by reason of which such corporation controls (within the meaning of section 2(a) of the Bank Holding Company Act of 1956) a bank or bank holding company, or such property is part of the property by reason of which such corporation did control a bank or a bank holding company before any property of the same kind was distributed under this subsection or exchanged under subsection (c)(3); and
(ii) the distribution is necessary or appropriate to effectuate the policies of such Act,

then no gain to the shareholder or security holder from the receipt of such property shall be recognized.

(2) DISTRIBUTIONS OF STOCK AND SECURITIES RECEIVED IN AN EXCHANGE TO WHICH SUBSECTION (c)(3) APPLIES.—If—

(A) a qualified bank holding corporation distributes—
(i) common stock received in an exchange to which subsection (c)(3) applies to a shareholder (with respect to its stock held by such shareholder), without the surrender by such shareholder of stock in such corporation; or
(ii) common stock received in an exchange to which subsection (c)(3) applies to a shareholder, in exchange for its common stock; or
(iii) preferred stock or common stock received in an exchange to which subsection (c)(3) applies to a shareholder, in exchange for its preferred stock; or
(iv) securities or preferred or common stock received in an exchange to which subsection (c)(3) applies to a security holder in exchange for its securities; and

(B) any preferred stock received has substantially the same terms as the preferred stock exchanged, and any securities received have substantially the same terms as the securities exchanged,

then, except as provided in subsection (f), no gain to the shareholder or security holder from the receipt of such stock or such securities or such stock and securities shall be recognized.

(3) NON PRO RATA DISTRIBUTIONS.—Paragraphs (1) and (2) shall apply to a distribution whether or not the distribution is pro rata with respect to all of the shareholders of the distributing qualified bank holding corporation.

(4) EXCEPTION.—This subsection shall not apply to any distribution by a corporation which has made any distribution pursuant to subsection (a).

(5) DISTRIBUTIONS INVOLVING GIFT OR COMPENSATION.—

In the case of a distribution to which paragraph (1) or (2) applies, but which—
(A) results in a gift, see section 2501, and following, or
(B) has the effect of the payment of compensation, see section 61(a)(1).

(c) PROPERTY ACQUIRED AFTER MAY 15, 1955.—

(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), subsection (a) or (b) shall not apply to—

(A) any property acquired by the distributing corporation after May 15, 1955, unless (i) gain to such corporation with respect to the receipt of such property was not recognized by reason of subsection (a) or (b), or (ii) such property was received by it in exchange for all of its stock in an exchange to which paragraph (2) or (3) applies, or (iii) such property was acquired by the distributing corporation in a transaction in which gain was not recognized under section 305 (a) or section 332, or under section 354 with respect to a reorganization described in section 368(a)(1)(E) or (F), or

(B) any property which was acquired by the distributing corporation in a distribution with respect to stock acquired by such corporation after May 15, 1955, unless such stock was acquired by such corporation (i) in a distribution (with respect to stock held by it on May 15, 1955, or with respect to stock in respect of which all previous applications of this clause are satisfied) with respect to which gain to it was not recognized by reason of subsection (a) or (b), or (ii) in exchange for all of its stock in an exchange to which paragraph (2)

or (3) applies, or (iii) in a transaction in which gain was not recognized under section 305(a) or section 332, or under section 354 with respect to a reorganization described in sections 368 (a)(1)(E) or (F), or

(C) any property acquired by the distributing corporation in a transaction in which gain was not recognized under section 332, unless such property was acquired from a corporation which, if it had been a qualified bank holding corporation, could have distributed such property under subsection (a)(1) or (b)(1).

(2) EXCHANGES INVOLVING PROHIBITED PROPERTY.—If—

(A) Any qualified bank holding corporation exchanges (i) property, which, under subsection (a)(1), such corporation could distribute directly to its shareholders or security holders without the recognition of gain to such shareholders or security holders, and other property (except property described in subsection (b)(1)(B)(i)), for (ii) all of the stock of a second corporation created and availed of solely for the purpose of receiving such property;

(B) immediately after the exchange, the qualified bank holding corporation distributes all of such stock in a manner prescribed in subsection (a)(2)(A); and

(C) before such exchange, the Board has certified (with respect to the property exchanged which consists of property which, under subsection (a)(1), such corporation could distribute directly to its shareholders or security holders without the recognition of gain) that the exchange and distribution are necessary or appropriate to effectuate section 4 of the Bank Holding Company Act of 1956,

then paragraph (1) shall not apply with respect to such distribution.

(3) EXCHANGES INVOLVING INTERESTS IN BANKS.—If—

(A) any qualified bank holding corporation exchanges (i) property which, under subsection (b)(1), such corporation could distribute directly to its shareholders or security holders without the recognition of gain to such shareholders or security holders, and other property (except prohibited property), for (ii) all of the stock of a second corporation created and availed of solely for the purpose of receiving such property;

(B) immediately after the exchange, the qualified bank holding corporation distributes all of such stock in a manner prescribed in subsection (b)(2)(A); and

(C) before such exchange, the Board has certified (with respect to the property exchanged which consists of property which, under subsection (b)(1), such corporation could distribute directly to its shareholders or security holders without the recognition of gain) that—

(i) such property is all or part of the property by reason of which such corporation controls (within the meaning of section 2(a) of the Bank Holding Company Act of 1956) a bank or bank holding company, or such property is part of the property by reason of which such corporation did control a bank or a bank holding company before any property of the same kind was distributed under subsection (b)(1) or exchanged under this paragraph; and

(ii) the exchange and distribution are necessary or appropriate to effectuate the policies of such Act,

then paragraph (1) shall not apply with respect to such distribution.

(d) DISTRIBUTIONS TO AVOID FEDERAL INCOME TAX.—

(1) PROHIBITED PROPERTY.—Subsection (a) shall not apply to a distribution if, in connection with such distribution, the distributing corporation retains, or transfers after May 15, 1955, to any corporation, property (other than prohibited property) as part of a plan one of the principal purposes of which is the distribution of the earnings and profits of any corporation.

(2) BANKING PROPERTY.—Subsection (b) shall not apply to a distribution if, in connection with such distribution, the distributing corporation retains, or transfers after May 15, 1955, to any corporation, property (other than property described in subsection (b)(1)(B)(i)) as part of a plan one of the principal purposes of which is the distribution of the earnings and profits of any corporation.

(3) CERTAIN CONTRIBUTIONS TO CAPITAL.—In the case of a distribution a portion of which is attributable to a transfer which is a contribution to the capital of a corporation, made after May 15, 1955, and prior to the date of the enactment of this part, if subsection (a) or (b) would apply to such

distribution but for the fact that, under paragraph (1) or (2) (as the case may be) of this subsection, such contribution to capital is part of a plan one of the principal purposes of which is to distribute the earnings and profits of any corporation, then, notwithstanding paragraph (1) or (2), subsection (a) or (b) (as the case may be) shall apply to that portion of such distribution not attributable to such contribution to capital, and shall not apply to that portion of such distribution attributable to such contribution to capital.

(e) FINAL CERTIFICATION.—

(1) FOR SUBSECTION (a).—Subsection (a) shall not apply with respect to any distribution by a corporation unless the Board certifies that, before the expiration of the period permitted under section 4(a) of the Bank Holding Company Act of 1956 (including any extensions thereof granted to such corporation under such section 4(a)), the corporation has disposed of all the property the disposition of which is necessary or appropriate to effectuate section 4 of such Act (or would have been so necessary or appropriate if the corporation had continued to be a bank holding company).

(2) FOR SUBSECTION (b).—

(A) Subsection (b) shall not apply with respect to any distribution by any corporation unless the Board certifies that, before the expiration of the period specified in subparagraph (B), the corporation has ceased to be a bank holding company.

(B) The period referred to in subparagraph (A) is the period which expires 2 years after the date of the enactment of this part or 2 years after the date on which the corporation becomes a bank holding company, whichever date is later. The Board is authorized, on application by any corporation, to extend such period from time to time with respect to such corporation for not more than one year at a time if, in its judgment, such an extension would not be detrimnetal to the public interest; except that such period may not in any case be extended beyond the date 5 years after the date of the enactment of this part or 5 years after the date on which the corporation becomes a bank holding company, whichever date is later.

(f) CERTAIN EXCHANGES OF SECURITIES.—In the case of an exchange described in subsection (a)(2)(A)(iv) or subsection (b)(2)(A)(iv), subsection (a) or subsection (b) (as the case may be) shall apply only to the extent that the principal amount of the securities received does not exceed the principal amount of the securities exchanged.

SEC. 1102. SPECIAL RULES.

(a) BASIS OF PROPERTY ACQUIRED IN DISTRIBUTIONS.—If, by reason of section 1101, gain is not recognized with respect to the receipt of any property, then, under regulations prescribed by the Secretary or his delegate—

(1) if the property is received by a shareholder with respect to stock, without the surrender by such shareholder of stock, the basis of the property received and of the stock with respect to which it is distributed shall, in the distributee's hands, be determined by allocating between such property and such stock the adjusted basis of such stock; or

(2) if the property is received by a shareholder in exchange for stock or by a security holder in exchange for securities, the basis of the property received shall, in the distributee's hands, be the same as the adjusted basis of the stock or securities exchanged, increased by—

(A) the amount of the property received which was treated as a dividend, and

(B) the amount of gain to the taxpayer recognized on the property received (not including any portion of such gain which was treated as a dividend).

(b) PERIODS OF LIMITATION.—The periods of limitation provided in section 6501 (relating to limitations on assessment and collection) shall not expire, with respect to any deficiency (including interest and additions to the tax) resulting solely from the receipt of property by shareholders in a distribution which is certified by the Board under subsection (a), (b), or (c) of section 1101, until five years after the distributing corporation notifies the Secretary or his delegate (in such manner and with such accompanying information as the Secretary or his delegate may be regulations prescribe) that the period (including extensions thereof) prescribed in section 4(a) of the Bank Holding Company Act of 1956, or section 1101(e)(2)(B), whichever is applicable, has expired; and such assessment may be made notwithstanding any provision of law or rule of law which would otherwise prevent such assessment.

(c) ALLOCATION OF EARNINGS AND PROFITS.—

(1) DISTRIBUTION OF STOCK IN A CONTROLLED CORPORATION.—In the case of a distribution by a qualified bank holding corporation under section 1101 (a) (1) or (b) (1) of stock in a controlled corporation, proper allocation with respect to the earnings and profits of the distributing corporation and the controlled corporation shall be made under regulations prescribed by the Secretary or his delegate.

(2) EXCHANGES DESCRIBED IN SECTION 1101 (c) (2) OR (3).—In the case of any exchange described in section 1101(c)(2) or (3), proper allocation with respect to the earnings and profits of the corporation transferring the property and the corporation receiving such property shall be made under regulations prescribed by the Secretary or his delegate.

(3) DEFINITION OF CONTROLLED CORPORATION.—For purposes of paragraph (1), the term "controlled corporation" means a corporation with respect to which at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock is owned by the distributing qualified bank holding corporation.

(d) ITEMIZATION OF PROPERTY.—In any certification under this part, the Board shall make such specification and itemization of property as may be necessary to carry out the provisions of this part.

SEC. 1103. DEFINITIONS.

(a) BANK HOLDING COMPANY.—For purposes of this part, the term "bank holding company" has the meaning assigned to such term by section 2 of the Bank Holding Company Act of 1956.

(b) QUALIFIED BANK HOLDING CORPORATION.—

(1) IN GENERAL.—Except as provided in paragraph (2), for purposes of this part the term "qualified bank holding corporation" means any corporation (as defined in section 7701(a)(3)) which is a bank holding company and which holds prohibited property acquired by it—

(A) on or before May 15, 1955.

(B) in a distribution in which gain to such corporation with respect to the receipt of such property was not recognized by reason of subsection (a) or (b) of section 1101, or

(C) in exchange for all of its stock in an exchange described in section 1101 (c) (2) or (c) (3).

(2) LIMITATIONS.—

(A) A bank holding company shall not be a qualified bank holding corporation, unless it would have been a bank holding company on May 15, 1955, if the Bank Holding Company Act of 1956 had been in effect on such date, or unless it is a bank holding company determined solely by reference to—

(i) property acquired by it on or before May 15, 1955,

(ii) property acquired by it in a distribution in which gain to such corporation with respect to the receipt of such property was not recognized by reason of subsection (a) or (b) of section 1101, and

(iii) property acquired by it in exchange for all of its stock in an exchange described in section 1101(c)(2) or (3).

(B) A bank holding company shall not be a qualified bank holding corporation by reason of property described in subparagraph (B) of paragraph (1) or clause (ii) of subparagraph (A) of this paragraph, unless such property was acquired in a distribution with respect to stock, which stock was acquired by such bank holding company—

(i) on or before May 15, 1955.

(ii) in a distribution (with respect to stock held by it on May 15, 1955, or with respect to stock in respect of which all previous applications of this clause are satisfied) with respect to which gain to it was not recognized by reason of subsection (a) or (b) of section 1101, or

(iii) in exchange for all of its stock in an exchange described in section 1101(c) (2) or (3).

(C) A corporation shall be treated as a qualified bank holding corporation only if the Board certifies that it satisfies the foregoing requirements of this subsection.

(c) PROHIBITED PROPERTY.—For purposes of this part, the term "prohibited property" means, in the case of any bank holding company, property (other than

nonexempt property) the disposition of which would be necessary or appropriate to effectuate section 4 of the Bank Holding Company Act of 1956 if such company continued to be a bank holding company beyond the period (including any extensions thereof) specified in subsection (a) of such section or in section 1101(e)(2)(B) of this part, as the case may be. The term "prohibited property" does not include shares of any company held by a bank holding company to the extent that the prohibitions of section 4 of the Bank Holding Company Act of 1956 do not apply to the ownership by such bank holding company of such property by reason of subsection (c)(5) of such section.

(d) NONEXEMPT PROPERTY.—For purposes of this part, the term "nonexempt property" means—

(1) obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace;

(2) securities issued by or guaranteed as to principal or interest by a gvoernment or subdivision thereof or by any instrumentality of a government or subdivision; or

(3) money, and the right to receive money not evidenced by a security or obligation (other than a security or obligation described in paragraph (1) or (2)).

(e) BOARD.—For purposes of this part, the term "Board" means the Board of Governors of the Federal Reserve System.

(b) The table of parts for subchapter O of chapter 1 of the Internal Revenue Code of 1954 is amended by adding at the end thereof the following:

Part VIII. Distributions pursuant to Bank Holding Company Act of 1956.

(c) The amendments made by this section shall apply with respect to taxable years ending after the date of the enactment of this Act.

SAVING PROVISION

SEC. 11. Nothing herein contained shall be interpreted or construed as approving any act, action, or conduct which is or has been or may be in violation of existing law, nor shall anything herein contained constitute a defense to any action, suit, or proceeding pending or hereafter instituted on account of any prohibited antitrust or monopolistic act, action, or conduct.

SEPARABILITY OF PROVISIONS

SEC. 12. If any provision of this Act, or the application of such provision to any person or circumstance, shall be held invalid, the remainder of the Act, and the application of such provision to persons or circumstances other than those to which it is held invalid, shall not be affected thereby.

Approved May 9, 1956.

PUBLIC LAW 545, EIGHTY-FOURTH CONGRESS
[CHAPTER 342, SECOND SESSION]
H. R. 7030 [14]

An act to amend and extend the Sugar Act of 1948, as amended, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 101

[14] House Report No. 1348, page 940 this Bulletin; Senate Report No. 1461, page 943 this Bulletin; House Conference Report No. 2174, page 945 this Bulletin.

(d) of the Sugar Act of 1948, as amended, is amended to read as follows:

(d) The term "raw sugar" means any sugars (exclusive of liquid sugar from foreign countries having liquid sugar quotas), whether or not principally of crystalline structure, which are to be further refined or improved in quality to produce any sugars principally of crystalline structure or liquid sugar.

SEC. 2. Section 101(e) of such Act is amended to read as follows:

(e) The term "direct-consumption sugar" means any sugars principally of crystalline structure and any liquid sugar (exclusive of liquid sugar from foreign countries having liquid sugar quotas), which are not to be further refined or improved in quality.

SEC. 3. Section 101(i) of such Act is amended by deleting the parenthetical word "(Clerget)".

SEC. 4. Section 101 of such Act is amended by adding at the end thereof a new paragraph to read as follows:

(n) The term "to be further refined or improved in quality" means to be subjected substantially to the processes of (1) affination or defecation, (2) clarification, and (3) further purification by adsorption or crystallization. The Secretary is authorized, after such hearing and upon such notice as he may by regulations prescribe, to determine whether specific processes to which sugars are subjected are sufficient to meet the requirements of this paragraph (n) and whether sugars of specific qualities are raw sugar within the meaning of paragraph (d) of this section, or direct-consumption sugar within the meaning of paragraph (e) of this section.

SEC. 5. Section 201 of such Act is amended by striking in the second sentence thereof the words "1947 prior to the termination of price control of sugar" and inserting in lieu thereof "1947–1949".

SEC. 6. Section 202(a) of such Act is amended to read as follows:

(a)(1) For domestic sugar-producing areas by apportioning among such areas four million four hundred and forty-four thousand short tons, raw value, as follows:

Area	*Short tons, raw value*
Domestic beet sugar	1,800,000
Mainland cane sugar	500,000
Hawaii	1,052,000
Puerto Rico	1,080,000
Virgin Islands	12,000

(2) To the above total of four million four hundred forty-four thousand short tons, raw value, there shall be added an amount equal to 55 per centum of the amount by which the Secretary's determination of requirements of consumers in the continental United States for the calendar year exceeds eight million three hundred and fifty thousand short tons, raw value. Such additional amount shall be apportioned among and added to the quotas established under paragraph (1) of this subsection for such domestic sugar-producing areas, respectively, as follows: (A) The first one hundred sixty-five thousand short tons, raw value, or any part thereof, by which quotas for the domestic areas are so increased shall be apportioned 51.5 per centum to the domestic beet sugar area and 48.5 per centum to the mainland cane sugar area; (B) the next twenty thousand short tons, raw value, or any part thereof, by which such quotas are so increased shall be apportioned to Puerto Rico; (C) the next three thousand short tons, raw value, or any part thereof, by which such quotas are so increased shall be apportioned to the Virgin Islands; (D) any additional amount shall be apportioned on the basis of the quotas established in paragraph (1) of this subsection as adjusted by subparagraphs (A), (B), and (C) of this paragraph (2).

SEC. 7. Section 202(c) of such Act is amended by striking out "For" after "(c)" and inserting in lieu thereof "(1) For the calendar year 1956, for" and by adding at the end thereof the following new paragraphs:

(2) For the calendar year 1957 and for each subsequent calendar year, for foreign countries other than the Republic of the Philippines, (A) by prorating to Cuba 96 per centum and to other foreign countries 4 per centum of the amount of sugar, raw value, by which eight million three hundred and fifty thousand short tons, raw value, or such lesser amount as determined pursuant to section 201 exceeds the sum of four million four hundred and forty-four thousand short tons, raw value, and the quota established pursuant to subsection (b) of this section; and (B) by prorating 45 per centum of the amount of sugar, raw value, by which the amount determined pursuant to section 201 exceeds the sum of eight million three hundred and fifty thousand short tons, raw value, as follows:

Country	*Per centum*
Cuba	29.59
Peru	4.33
Dominican Republic	4.95
Mexico	5.10
Other countries	1.03
	45.00

The above proration of 1.03 per centum to foreign countries other than Cuba, the Republic of the Philippines, Peru, the Dominican Republic, and Mexico shall be apportioned to such other countries whose average entries within the quotas during 1953 and 1954 exceeded one thousand short tons, raw value, on the basis of the average entries within the quotas from each such country for the years 1951, 1952, 1953, and 1954.

(3) For the calendar year 1957 and for each subsequent calendar year, the proration of 4 per centum under paragraph (2) (A) of this subsection for foreign countries other than Cuba and the Republic of the Philippines shall be apportioned, first, by assigning to each such foreign country whose average entries within the quotas during the years 1953 and 1954 were less than one thousand short tons, raw value, a proration equal to its average entries within the quotas during 1953 and 1954; second, by assigning to each such foreign country whose average entries within the quotas during 1953 and 1954 were not less than one thousand nor more than two thousand short tons, raw value, a proration of three thousand short tons, raw value; third, by assigning to each foreign country whose average entries within the quotas during 1953 and 1954 were more than two thousand and less than three thousand short tons, raw value, a proration equal to the average entries from each such country within the quotas during 1953 and 1954, plus two thousand short tons, raw value; fourth, by assigning to each foreign country whose average entries within the quotas during 1953 and 1954 were not less than three thousand nor more than ten thousand short tons, raw value, a proration equal to the average entries from each such country within the quotas during 1953 and 1954; and, fifth, by prorating the balance of such proration to such foreign countries whose average entries within the quotas during 1953 and 1954 exceeded ten thousand short tons, raw value, on the basis of the average entries within the quotas from each such country for the years 1951, 1952, 1953, and 1954.

SEC. 8. Section 202 of such Act is amended by adding the following new subsection:

(e) Whenever in any year any foreign country with a quota or proration thereof of more than ten thousand short tons fails to fill such quota or proration by more than 10 per centum and at any time during such year the world price of sugar exceeds the domestic price, the quota or proration thereof for such country for subsequent years shall be reduced by an amount equal to the amount by which such country failed to fill its quota or proration thereof, unless the Secretary finds that such failure was due to crop disaster or force majeure or finds that such reduction would be contrary to the objectives of this Act. Any reduction hereunder shall be prorated in the same manner as deficits are prorated under section 204.

SEC. 9. (a) The second sentence of section 204(a) of such Act is amended by inserting before the period at the end thereof a colon and the following: *Provided*, That any deficit in any domestic sugar-producing area occurring by reason of inability to market that part of the quota for such area allotted under the provisions of section

202(a) (2) shall first be prorated to other domestic areas on the basis of the quotas then in effect".

(b) The last paragraph of section 204(a) of such Act is amended by inserting before the period at the end thereof a semicolon and the following: "except that in the case of proration of any such deficit in any domestic sugar-producing area occurring by reason of inability to market that part of the quota for such area allotted under and by reason of section 202(a) (2), the Secretary shall apportion the unfilled amount on such basis and to such other domestic areas as he determines is required to fill such deficit, and if he finds that no domestic area will be able to supply such unfilled amount, he shall add it to the quota for Cuba".

SEC. 10. Section 205(a) of such Act is amended by inserting immediately before the final sentence thereof the following: "In making such allotments, the Secretary may also take into consideration and make due allowance for the adverse effect of drought, storm, flood, freeze, disease, insects, or other similar abnormal and uncontrollable conditions seriously and broadly affecting any general area served by the factory or factories of such person.".

SEC. 11. (a) Section 207 (a) of such Act is amended by adding after the word "year" the following: ", plus an amount equal to the same percentage of twenty-nine thousand six hundred and sixteen short tons, raw value, that the increase in the quota for Hawaii under section 202 is of one million fifty-two thousand short tons, raw value,".

(b) Section 207(b) of such Act is amended by striking the period at the end thereof and by adding the following: "which shall be principally of crystalline structure, plus an amount equal to the same percentage of one hundred twenty-six thousand and thirty-three short tons, raw value, that the increase in the quota for Puerto Rico under section 202 is of one million eight thousand short tons, raw value, which latter amount may be filled by direct-consumption sugar whether or not principally of crystalline structure.".

SEC. 12. Section 207(h) of such Act is amended by striking out "The" after "(h)" and inserting in lieu thereof "(1) For the calendar year 1956, the" and by adding the following new paragraph:

(2) For the calendar year 1957 and each subsequent calendar year, the quota for foreign countries other than Cuba and the Republic of the Philippines may be filled by direct-consumption sugar to the extent of 1.36 per centum of the amount of sugar determined pursuant to section 201 less the sum of the quotas established in subsections (a) and (b) of section 202: *Provided*, That such limitation shall not apply to countries receiving prorations under section 202(c) of seven thousand short tons or less. The direct-consumption portion of such quota which is subject to the 1.36 per centum limitation referred to above shall be prorated to countries which receive prorations under section 202 (c) of more than seven thousand short tons on the basis of average imports of direct-consumption sugar within the quota for the years 1951, 1952, 1953, and 1954.

SEC. 13. Section 301(b) of such Act is amended by inserting after the words "(or processed)" the following: ", except for livestock feed, or for the production of livestock feed, as determined by the Secretary,".

SEC. 14. Section 302(b) of such Act is amended by inserting after "(or processed)" the words "within the proportionate share" and by striking the period at the end thereof and inserting the following: "and of the producers in any local producing area whose past production has been adversely, seriously, and generally affected by

drought, storm, flood, freeze, disease, insects, or other similar abnormal and uncontrollable conditions. For the purposes of establishing proportionate shares hereunder and in order to encourage wise use of land resources, foster greater diversification of agricultural production, and promote the conservation of soil and water resources in Puerto Rico, the Secretary, on application of any owner of a farm in Puerto Rico, is hereby authorized, whenever he determines it to be in the public interest and to facilitate the sale or rental of land for other productive purposes, to transfer the sugarcane production record for any parcel or parcels of land in Puerto Rico owned by the applicant to any other parcel or parcels of land owned by such applicant in Puerto Rico.".

SEC. 15. Section 405 of such Act is amended by inserting "(a)" at the beginning thereof, by striking out "(a)" and "(b)" and inserting in lieu thereof "(1)" and "(2)", respectively, and by adding the following new subsection:

(b) Any person whose sugar processing operations otherwise meet the requirements of section 101(n) and who subjects to such processes sugar imported or brought into the continental United States under a declaration that it is raw sugar but which sugar subsequently is determined to be of direct-consumption quality, shall forfeit to the United States a sum equal to 1 cent per pound for each pound, raw value, of such sugar in excess of that part of the direct-consumption portion of the applicable quota or proration or allotment thereof remaining unfilled at the time of such determination, which forfeiture shall be recoverable in a civil suit brought in the name of the United States.

SEC. 16. Section 407 of such Act is amended by adding at the end thereof the following sentence: "The provisions of this section shall not apply to persons whose services are obtained pursuant to section 305.".

SEC. 17. Section 411 of such Act is renumbered as section 412, section 412 of such Act is renumbered as section 413, and a new section 411 inserted as follows:

SEC. 411. The Secretary is authorized to issue such regulations as may be necessary to carry out article 7 of the International Sugar Agreement for the Regulation of the Production and Marketing of Sugar (ratified by and with the advice and consent of the United States Senate on April 29, 1954), restricting importations of sugar into the United States from foreign countries not participating in such agreeemnt, or to carry out the corresponding provisions of any such future agreements ratified by and with the advice and consent of the United States Senate.

SEC. 18. Renumbered section 412 of such Act (relating to termination of the powers of the Secretary under the Act) is amended by striking out "1956" in each place it appears therein and inserting in lieu thereof "1960".

SEC. 19. Sections 4501(c) and 6412(d) (relating to the termination of taxes on sugar) of the Internal Revenue Code of 1954 are amended by striking out "1957" in each place it appears therein and inserting in lieu thereof "1961".

SEC. 20. Section 4502(4), chapter 37, subchapter A, "Sugar", of the Internal Revenue Code of 1954 is amended as follows: Strike out the parenthetical word "(Clerget)" where it occurs in the first sentence and delete the second sentence thereof.

SEC. 21. (a) Section 4504, chapter 37, subchapter A, "Sugar", of the Internal Revenue Code of 1954 is amended by adding before the period at the end thereof the following: ", and except that such tax

may be subject to refunds as a tax under the provisions of section 6418 (a)".

(b) Section 6418(a) of chapter 65 of the Internal Revenue Code of 1954 is amended by striking out the "(a)" immediately following "section 4501".

SEC. 22. Except as otherwise provided, the amendments made hereby shall become effective as of January 1, 1956, except that sections 1 through 4 shall become effective upon publication in the Federal Register of regulations implementing such sections, or six months after the date of enactment of this Act, whichever is earlier.

Approved May 29, 1956.

SUBPART C.—COMMITTEE REPORTS

[S. 2577—P. L. 511]

BANK HOLDING COMPANY ACT OF 1955

[Senate Report No. 1095, Eighty-fourth Congress, First Session. Calendar No. 1107] [1]

[July 25, 1955]

Mr. Robertson, from the Committee on Banking and Currency, submitted the following report [To accompany S. 2577]:

The Committee on Banking and Currency, to whom was referred the bill (S. 2577) to define bank holding companies, control their future expansion, and require divestment of their nonbanking interests, having considered the same, report favorably thereon with an amendment and recommended that the bill, as amended, do pass.

* * * * * * *

DEFINITION OF BANK HOLDING COMPANY

The committee is satisfied that legislation in the bank holding field will be adequate if it applies to any company controlling two or more banks. In order to accomplish this result, the bill defines a bank holding company as one meeting any of the three following tests:

(1) A company which directly or indirectly owns, controls, or holds with power to vote 25 percent or more of the voting shares of each of two or more banks or of a bank holding company;

(2) A company which controls the election of the majority of the directors of each of two or more banks; or

(3) A company for the benefit of whose shareholders or members 25 percent or more of the voting shares of each of two or more banks or a bank holding company is held by trustees.

The bill also includes in its scope any successor to a bank holding company where the relationship between the successor and the bank holding company is such that the successor's acquisition of bank shares from the company causes no substantial change in control of the bank or beneficial ownership of shares.

Section 3(a) of the bill expressly excludes from the definition of bank holding company the following:

(1) A bank controlling shares in a fiduciary capacity, unless the shares are held for the profit of the banks shareholders;

(2) A company registered under the Investment Company Act of 1940 prior to May 15, 1955, and its affiliates, unless the company or any affiliate, as the case may be, directly owns 25 percent or more of the voting shares of each of two or more banks;

(3) A company engaged in bona fide underwriting of securities held only for a period of time permitting their sale on a reasonable basis; and

(4) A company formed for the sole purpose for participating in a proxy solicitation which acquired control of voting rights during the course of such solicitation.

The exemption for shares held in a fiduciary capacity is necessary to enable banks to carry on a normal trust business. The exemption for companies registered under the Investment Company Act of 1940 is included in the bill on the theory that any such company is adequately supervised by the Securities and Exchange Commission, which administers that act. Among the purposes listed in that act are the mitigation of undue concentration of the control of investment companies through pyramiding or inequitable methods of control, the mitigation of inequitable distribution of such companies, and the mitigaton of irresponsible management of such companies. Your committee believes that SEC regulation in such cases is closely akin to the purposes of this bill and that it is therefore unnecessary to require a registrant under the Investment Company Act of 1940 to be subjected to the additional regulatory authority granted to the Board of Governors of the Federal Reserve System by this bill. It will not be possible however, for a bank holding company to evade regula-

[1] This publication of the Committee Report is restricted to excerpts involving internal revenue matters.

tions under the proposed legislation by registering as an investment company since this exception applies only to a bank holding company registered under the Investment Company Act of 1940 prior to May 15, 1955, which does not directly own 25 percent or more of the voting shares of each of two or more banks. An affiliated company of such a company, within the meaning of the Investment Company Act of 1940, is also exempted from the definition of a bank holding company under this bill unless the affilate directly owns 25 percent or more of the voting shares of two or more banks.

The exemption of a company engaged in the underwriting of securities is included in the bill because of the possibility that such a company might happen to acquire title, in the course of its normal underwriting business, to 25 percent or more of the voting shares of each of two or more banks. Should this transpire, it should be noted that the company must dispose of such shares within a period of time adequate to permit their sale upon a reasonable basis, in order to continue to receive the benefits of exemption from the definition of a bank holding company.

The remaining exemption from the definition of bank holding company is included to allow formation of a bona fide stockholders' committee or a similar organization for the sole purpose of soliciting proxies in order to gain control of voting rights of shares. Your committee is of the opinion that such an exemption is justified in order to prevent undue interference with proxy contests. It was pointed out that if in the course of such a contest, a company so formed acquires control of the voting rights of 25 percent or more of the voting shares of each of two or more banks, it might well find itself included within the definition of a bank holding company in this bill in the absence of a specific exemption. The provision is intended to provide an exemption only for qualified companies during the course of the proxy contest. The exemption is not intended to carry over for the benefit of any such company following the termination of the proxy contest.

DEFINITION OF COMPANY

Under the bill, only a "company" as defined in the bill can become a bank holding company. Company is expressly defined to mean any corporation, business trust, association, or similar organization. It will be noted that an individual, as such, is not included in this definition. Moreover, the definition expressly excludes: (1) any corporation the majority of whose shares are owned by the United States or any State; (2) any corporation or community chest, fund, or foundation, organized or operated exclusively as a religious, charitable, or educational organization, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation; and (3) any partnership.

The first exclusion is provided on the theory that any corporation the majority of whose shares are owned by the United States or any State is subject to the control of either the United States or of the State owning such shares. The exclusion of religious and other charitable organizations is similar to that granted to such organizations under the Internal Revenue Code. The committee's attention was invited to at least one case where a bona fide religious organization controls two or more banks as well as nonbanking interests as an incident to its main purpose. In the opinion of the committee, even though these incidental business activities are organized for the primary purpose of profit, the very nature of the religious organization itself precludes the possibility of violating the spirit of this bill.

The third exemption from the definition of "company" is granted to any partnership because the attributes of a partnership are similar to those presented by an individual in the sense that neither has perpetual duration. As the individual's personal control of business activities ceases with his death, any business control exercised by a partnership will likewise terminate upon the death of either partner. Usually, the death of an individual who controls banks is accompanied by a diffusion of ownership of such banks.

By way of contrast, corporations and similar organizations may have perpetual existence. The death of any individual member of a corporation has no effect upon continued control of banks by the corporation. This bill is designed to bring under control those types of entities that may be used as media for acquiring and maintaining in perpetuity management and control of bank shares or assets.

The exemptions previously mentioned in this report are the only ones given by this bill from the definitions of company and bank holding company. All other such organizations are required by the bill to subject themselves to such regulation as the bill prescribes as a condition to growth by means of bank share or asset acquisition.

Your committee did not deem it necessary to include within the scope of this bill any company which manages or controls no more than a single bank. It is possible to conjure up visions of monopolistic control of banking in a given area through ownership of a single bank with many and widespread branches. However, in the opinion of your committee, no present danger of such control through the bank holding company device threatens to a degree sufficient to warrant inclusion of such a company within the scope of this bill. Should legislation of that nature prove desirable in the future, the Congress is free to act upon a showing of need for such a law.

OTHER DEFINITIONS

This bill defines banks to include both National banks and State banks, savings banks, and trust companies. It excludes, however, organizations that do no business in the United States and those organized for foreign or international banking under section 25(a) of the Federal Reserve Act. A District bank is defined as a State bank organized or operating under the laws of the District of Columbia. A State member bank is defined to mean a State bank which is a member of the Federal Reserve System.

The bill defines a subsidiary of a bank holding company in terms of a company owned or controlled by a bank holding company under the same general tests as laid down for ownership or control exercised by a bank holding company.

A successor is defined as a company acquiring bank shares from a bank holding company with no resulting substantial change in bank beneficial ownership or control. The Federal Reserve Board is empowered to define successor in more detail by regulation in order to prevent evasion of the purposes of this bill.

The committee is of the opinion that the definitions in this bill will adequately cover the organizations which should be included in the scope of this bill without unnecessarily encompassing organizations that need not be included in order to accomplish the purposes of the bill.

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DIVESTMENT OF NONBANKING ASSETS

The bill prohibits a bank holding company from acquiring, after the passage of this bill, ownership or control of any voting shares of any company which is not a bank. It also provides that existing bank holding companies cannot retain ownership or control, for more than 2 years after the date of passage of this bill, of any voting shares of a company which is not related to banking. Nor can any such company engage in a business other than banking or managing or controlling banks or furnishing or performing services for any bank of which it owns or controls 25 percent or more of the voting shares. Upon application by a bank holding company, the Federal Reserve Board is authorized to extend the 2-year deadline for periods of not more than 1 year at a time, provided that in no event can the extensions extend the total divestment period to longer than 5 years after the date of enactment of the bill, or 5 years after the date upon which a company becomes a bank holding company, whichever is later. Appropriate exceptions are made in the bill in order to enable bank holding companies to retain ownership and control of nonbanking assets in cases where such retention will not violate the purposes of the bill. Seven classes of such exemptions are provided as follows:

(1) Shares owned or acquired by a bank holding company in a company engaged solely in holding or operating properties used primarily by a bank in the bank holding company system or acquired for future use of such bank in its operations; and shares owned or acquired by a bank holding company in any company engaged solely in conducting a safe deposit business or serving the holding company and banks in the holding company system with respect to such functions as audits, appraisals, investment counsel, or the liquidation of assets acquired from the bank holding company and the banks within the bank holding company system;

(2) Shares acquired by a bank holding company that is a bank or any of its banking subsidaries in satisfaction of a debt previously contracted in good faith (in which event such shares must be disposed of within 2 years after their acquisition of 2 years after the passage of this bill whichever is later);

(3) Shares acquired by a bank holding company from any of its subsidiaries by virtue of action initiated by any examining Federal or State authority (but such shares must be disposed of within 2 years after their acquisition or 2 years after the passage of this bill, whichever is later);

(4) Shares held or acquired in a fiduciary capacity by a bank holding company that is a bank or shares eligible for investment by national banks;

(5) Shares of any company that do not represent more than 5 percent of the company's outstanding voting securities and that do not have a value greater than 5 percent of the total asset value of the bank holding company;

(6) Shares of any company whose activities of a financial, fiduciary, or insurance nature are determined by the Federal Reserve Board to be so closely related to the banking business as to constitute a proper incident to that business, and to make unnecessary the divestment of such shares in order to carry out the purposes of the bill; or

(7) Any bank holding company which is a labor, agricultural, or horticultural organization.

It seems obvious that the foregoing exemptions with reference to bank premises, safe-deposit business, bank-servicing organizations, collection of debts, involuntary acquisition of shares, and acquisition of shares in a fiduciary capacity, or permissible investments for national banks, are all appropriate in order to enable a bank holding company to carry on operations closely related to banking. The same reasoning dictates the inclusion of exemption (5). Moreover, control of no more than 5 percent of the voting securities of a company is not deemed adequate for effective control of that company. It should be further noted that no bank holding company can enjoy the benefits of this exemption if its investment in the shares of the company exceed 5 percent of the total asset value of the bank holding company.

Exemption (6) has been included by the committee as a necessary provision to enable the administering authority under this bill to permit the retention by a bank holding company of activities found to be closely related to banking. It should be noted that the Board is required to make its determination after due notice and hearing and on the basis of the record made at the hearing. The Federal Reserve Board's action is required to be taken in the form of an order, as to which any aggrieved party can obtain a review in the appropriate court of appeals. In the opinion of your committee, certain activities of a financial, fiduciary, or insurance nature are obviously so closely related to banking as to require no divestment by a bank holding company. For example, the operation of a credit life-insurance program in connection with bank loans is clearly within the scope of banking operations as presently conducted. So is the operation of an insurance program under which the insurance proceeds retire the outstanding balance of the mortgage upon the death of the mortgagor in cases where the bank holds the mortgage. However, there are many other activities of a financial, fiduciary, or insurance nature which cannot be determined to be closely related to banking without a careful examination of the particular type of business carried on under such activity. For this reason your committee deems it advisable to provide a forum before an appropriate Federal authority in which decisions concerning the relationship of such activities to banking can be determined in each case on its merits.

Exemption (7) concerning labor, agricultural and horticultural organizations is closely akin to the similar exemption from Federal income taxes granted to such organizations. In order to be entitled to the exemption under this bill, no net income derived by any such organization can inure to the benefit of any individual. Such organizations must be formed primarily for the betterment of the working conditions of their members, in the case of labor organizations, and for the improvement in grade of agricultural or horticultural products in the case of agricultural or horticultural organizations. As in the case of the Federal income tax exemption, such agricultural and horticultural organizations as county fairs, quasi-public in nature, that are designed to encourage better products through a system of awards, would qualify for exemption under this bill. However, the growing of agricultural or horticultural products for profit by an agricultural or horticultural organization would not

entitle such organization to the benefits of exemption from the divestment features of this bill.

The seven specific classes of exemption from the divestment requirements of the bill do not excuse those exempted from compliance with the remaining provisions of the bill. Such exempted organizations or companies will be required to register under the bill with the Federal Reserve Board and to obtain the approval of that Board in the event the organization or company wishes to acquire additional voting shares or assets of any bank, if such approval is otherwise required under the bill for bank holding companies.

Your committee holds the opinion that bank holding companies should confine their activities to the control and management of banks and activities closely related to banking. They should not combine management and control of banking activities with management and control of nonbanking activities. The divestment requirements in this bill are designed to remove the danger that a bank holding company might misuse or abuse the resources of a bank it controls in order to gain an advantage in the operation of the non-banking activities it controls.

The committee gave consideration to a suggestion that present bank holding companies be allowed to retain their existing nonbanking assets and that the bill merely prohibit such companies from acquiring additional nonbanking assets. However, the committee believes that to adopt this course of action would give an unfair competitive advantage to existing bank holding companies over bank holding companies which might be formed in the future consistent with the provisions of this bill. Your committee believes that in general all bank holding companies should be required to observe the same ground rules concerning formation and operation, insofar as Federal legislation is concerned.

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TAX RELIEF FOR DISTRIBUTIONS MADE

H. R. 6227, as passed by the House of Representatives, would add a new part VIII to subchapter O of the Internal Revenue Code of 1954. Under this new part, tax relief is accorded to distributions made pursuant to the provisions of this bill within the period prescribed therein. Your committee has adopted the tax provisions contained in the House bill with certain technical changes.

In general, a corporation which comes within the terms of the act as a bank holding company is given its choice of two alternative routes (that is, to remain a bank holding company, or to dispose of its interests in banks).

If the corporation decides to remain a bank holding company subject to the supervision of the Federal Reserve Board, it may distribute any "prohibited property," which the Board certifies is necessary or appropriate to comply with the act, to its shareholders without the recognition of gain by the shareholders on the distribution. For this purpose "prohibited property," in general, means stock, securities and other obligations, or other assets of nonbanking businesses to the extent the bank holding company is required to divest itself of such assets under section 4(a) of the bill. The term, however, does not include cash, Government bonds, or certain short-term obligations. In the ordinary case cash and cash equivalents, such as Government bonds and short-term obligations, will not come within section 4(a) of the bill as property which must be disposed of by the bank holding company. It is believed desirable, however, to expressly exclude cash, etc., from the definition of "prohibited property," since a similar exclusion is contained in the comparable provisions of part VI of subchapter O, relating to exchanges in obedience to SEC orders.

With respect to the distributing corporation, the usual provisions of the Internal Revenue Code of 1954 apply. Under these provisions, gain generally is not recognized to the distributing corporation except under unusual circumstances such as the distribution of LIFO inventory, the distribution of property subject to a liability in excess of the adjusted basis, or the distribution of certain installment obligations.

The distribution of "prohibited property" may be made either directly to the shareholders of the corporation which is a bank holding company or may be transferred to a wholly owned subsidiary expressly created for purposes of receiving the prohibited property. The stock of the subsidiary must be immediately distributed to the shareholders of the corporation which is a bank holding company if the distribution is to be made under this bill without the recognition of gain to the shareholders.

If a corporation which qualifies as a bank holding company under the act chooses the second alternative route, it may distribute to its shareholders any bank stock or other property of a kind which causes it to be a bank holding company, without the recognition of gain to the recipient stockholders. The Board must certify, however, that distribution of property of that kind is necessary or appropriate to effectuate the policies of the bill. In such a case, the corporation may, for example, distribute to its shareholders all of its shares of bank stock without the recognition of gain even though it would be possible to retain shares of stock in one bank without being classified as a bank holding company. Your committee believes that this treatment is necessary because a corporation which is compelled to divest itself of part of its bank stock by reason of the bill may wish to distribute all of its shares of bank stock, so that no possibility will exist that it will be classified as a bank holding company in the future.

Your committee contemplates that the Federal Reserve Board in the discharge of its functions in making certifications that exchanges and distributions are necessary or appropriate to effectuate the purposes of the bill will carefully scrutinize the facts and circumstances in each case to prevent abuses and will cooperate fully with the Treasury Department to this end. Although the time of recognition of gain may be legitimately shifted under the provisions of this part, nothing in these provisions is to be construed or applied in such manner as to permit tax evasion or sham transactions entered into for avoiding tax.

Your committee has restricted the nonrecognition treatment described above the property which was owned on May 15, 1955. This restriction is deemed necessary to prevent corporations from purchasing interests in banks or other property in order that their shareholders may get the benefit of the tax treatment provided in the bill. The restriction would not apply, however, if the property was received in a transaction in which gain was not recognized because of the general rules described above. For example, if prohibited property was distributed by a subsidiary to its parent in a corporate chain without recognition of gain to the parent by reason of these provisions, the parent, in turn, may distribute the property to its own shareholders without recognition of gain under a certification by the Board, even though the property was acquired by the parent after May 15, 1955. Similarly, the May 15, 1955, cutoff date is not applicable where the prohibited property or bank stock (or other similar property) certified by the Board is transferred to a wholly owned subsidiary created for that purpose and the stock of the subsidiary is immediately distributed by the qualified bank holding corporation to its shareholders.

As in the case of the first alternative route, nonrecognition treatment is available whether the bank stock or other similar property certified by the Board is distributed directly to shareholders or whether it is first transferred to a wholly owned subsidiary expressly created for that purpose and the stock of the subsidiary is then immediately distributed to the shareholders of the parent.

To prevent certain tax avoidance possibilities that might otherwise exist, your committee's bill does not extend nonrecognition treatment, under the general rules described above, to any portion of a distribution attributable to a contribution to the capital of any corporation where the contribution is made after May 15, 1955. This restriction applies whether or not the contribution to capital is made by a shareholder of the corporation receiving such contribution. In the case of a contribution to the capital of a bank, however, the limitation does not apply if it is determined that avoidance of Federal income tax was not a principal purpose of the contribution.

Where the nonrecognition treatment has been extended to "prohibited property" which has been distributed by the corporation which is a bank holding company, a final certification must be obtained from the Board that the corporation has divested itself of all property necessary for compliance with the bill within the statutory period permitted for divestment. If this final certification is not obtained, the transactions previously permitted to be made wihout recognition of gain are reopened and tax may be imposed in such cases. For this purpose the statute of limitations on assessment of a deficiency resulting solely from the distribution of prohibited property which has been certified by the Board under section 1101(a) does not expire until 5 years after the corporation gives notification that the period prescribed in section 4(a) of the bill has expired.

A similar final certification is required where nonrecognition treatment has been originally accorded to the distribution of bank stock or similar property of a kind which the Board has certified as necessary so that the corporation will cease to be a bank holding company. In this case the tax provisions of the

bill provide that the Board must give a final certification that the corporation has ceased to be a bank holding company within 2 years after the date of enactment of the bill or 2 years after the date on which the corporation becomes a bank holding company, whichever is later, unless the time has been extended by the Board for 1-year renewals not to exceed 5 years from the date of enactment of the bill or the date on which the corporation becomes a bank holding company, whichever is later. The statutory period for the assessment of a deficiency resulting solely from such distribution is extended in the same manner as in the case of the distribution of prohibited property.

The basis of stock or other property received by a distributee without recognition of gain under the provisions of the bill is determined by allocating the adjusted basis of the stock with respect to which the distribution was made between such stock and the property so distributed. This rule is similar to the general rule for allocation of basis in the case of a stock dividend. The bill provides that the allocation shall be made under regulations provided by the Secretary or his delegate.

SECTION-BY-SECTION ANALYSIS OF THE BILL

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Section 1.—This section provides that this act may be cited as the Bank Holding Company Act of 1955.

Section 2.—This section defines the terms used in the bill.

Subsection (a) defines the term "bank holding company" to mean (1) any company which directly or indirectly owns or controls 25 percent or more of the voting shares of 2 or more banks or of a company which is or becomes a bank holding company by virtue of this act; or (2) any company controlling the election of a majority of the directors or 2 or more banks; or (3) any company for whose shareholders trustees hold 25 percent or more of stock of 2 or more banks or of bank holding company. A successor to any such bank holding company is deemed to be a bank holding company as of the date the predecessor company became a bank holding company. Excluded from the definition are (*a*) any bank controlling shares in a fiduciary capacity (unless controlled for benefit of the bank's shareholders); (*b*) any company or affiliate registered under Investment Company Act of 1940, prior to May 15, 1955, unless its own 25 percent of shares of 2 or more banks; (*c*) any company engaged in underwriting securities; and (*d*) any company formed for the purpose of soliciting proxies.

Subsection (b) defines the term "company" to include any corporation, business trust, association, or similar organization. However, (1) any company the majority of the shares of which are owned by the Federal Government or by any State, (2) any nonprofit religious, charitable, or educational organization, and (3) any partnership—are excluded from the definition.

Subsection (c) defines the term "bank" to include any national or State bank, savings bank or trust company, but excludes any organization which does not do business within the United States. The subsection also defines the terms "State member bank" and "district bank."

Subsection (d) defines a "subsidiary" of a specified bank holding company in terms of the tests applicable to a bank holding company.

Subsection (e) defines the term "successor" and gives the Board of Governors of the Federal Reserve System the right by regulation to further define the term "successor" to the extent necessary to prevent evasion of the purposes of the act.

Subsection (f) makes clear that where the term "Board" is used in the act the reference is to the Board of Governors of the Federal Reserve System.

Section 3.—The provisions of this section relate to future acquisitions of bank shares or bank assets by bank holding companies or by companies which thereby would become bank holding companies and to the merger or consolidation of bank holding companies.

Subsection (a) makes it unlawful except with prior Board approval (1) for a company to become a bank holding company; (2) for a bank holding company or subsidiary to acquire more than 5 percent of the voting shares of any bank; (3) for a bank holding company or subsidiary, other than a bank, to acquire substantially all the assets of a bank; or (4) for a bank holding company to merge or consolidate with any other bank holding company. This prohibition does not apply to (*a*) any bank holding company, which is a bank acquiring shares in a fiduciary capacity (unless for benefit of its own shareholders or in

collecting debt (but must divest in 2 years, and (b) any bank holding company, which is a bank acquiring additional shares in a bank of which it owns a majority of the voting shares.

Subsection (b) provides that 30 days before approving any acquisition, merger or consolidation, the Board shall notify: (i) Comptroller of the Currency if bank to be acquired is a national or District bank; (ii) State supervisory authority if bank being acquired is a State bank. If such notified authority disapproves it in writing within 30 days, the Board will hold a hearing to grant or deny the application.

Subsection (c) sets forth the standards to be followed by the Board in granting or denying approval including (1) bank holding company's and bank's financial history and conditions; (2) prospects; (3) management; (4) convenience, needs, and welfare of area concerned; and (5) sound banking, public interest, and bank competition.

Section 4.—This section relates to bank holding company interests in nonbanking organizations and provides for separation of banking and nonbanking interests.

Subsection (a) prohibits a bank holding company from acquiring or retaining voting shares of any nonbank company or engaging in a business other than (1) banking, (2) managing or controlling banks, or (3) furnishing services to or providing services for a subsidiary bank. Divestment of nonbank business is required within 2 years after the date of this act or from date of becoming a bank holding company, whichever is later. The Board may extend this time up to not more than 5 years.

Subsection (b) prohibits a bank holding company after 2 years from date of enactment from (1) making any statement on its shares that they represent shares of any other company except a bank or a bank holding company, or (2) conditioning in any manner ownership, sale, or transfer of its shares upon the ownership, sale or transfer of shares of any other company except a bank or a bank holding company.

Subsection (c) provides appropriate exemptions to the blanket prohibitions on bank holding company investments or activities set forth in subsection (a).

Paragraph (1) exempts investments by a bank holding company in companies obviously incidental to the business of banking, such as holding bank premises, conducting a safe deposit business, or providing services such as auditing, appraisal, and investment counsel, or in liquidating assets acquired from the bank holding company or its subsidiaries.

Paragraph (2) exempts for a 2-year period investments acquired by a bank holding company which is a bank, in satisfaction of a debt previously contracted.

Paragraph (3) exempts for a 2-year period investments acquired by a bank holding company from any subsidiary which is requested to dispose of such investment by a Federal or State examining authority.

Paragraph (4) exempts investments held by a bank (which is a bank holding company) in a fiduciary capacity, and investments eligible for national bank investment under section 5136 of the Revised Statutes.

Paragraph (5) exempts limited general investments of a bank holding company from the investment prohibitions of the act. A bank holding company may own investments in any company provided such investment does not include more than 5 percent of the outstanding voting securities of such company and provided the value of the investment does not exceed 5 percent of the total assets of the holding company.

Paragraph (6) authorizes the Board to exempt shares of any company all the activities of which are of a financial, fiduciary, or insurance nature and are determined to be so closely related to the business of banking as to be a proper incident thereto.

Paragraph (7) exempts any bank holding company which is a labor, agricultural or horticultural organization.

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Section 10.—This section amends subchapter O of chapter 1 of the Internal Revenue Code of 1954 by adding a new part VIII. This part VIII specifies the extent to which (during a transition period after the enactment of the bill) gain will not be recognized upon receipt of property by a shareholder of a bank holding company, if such distribution is made pursuant to a certification by the Board of Governors of the Federal Reserve System that such distribution is necessary or appropriate to effectuate the Bank Holding Company Act of 1955. The provisions of the new part VIII are restricted by their own terms to the gain

directly attributable to the receipt of property in the distributions specifically described.

The rules contained in part VIII are in addition to the other provisions of subtitle A of the Internal Revenue Code of 1954 (such as provisions relating to the recognition or nonrecognition of gain to a corporation making distributions, the provisions under which tax-free reorganizations may be effectuated, etc.). Many of these other provisions are contained in subchapter C of chapter 1 of such code (relating to corporate distributions and reorganizations). The provisions of part VIII supersede the other provisions of chapter 1 only in the cases qualifying under part VIII, and in those cases only to the extent specific provision is contained in part VIII.

Your committee has adopted the tax provisions contained in the House bill with certain technical changes.

Section 1101 sets forth the conditions for nonrecognition of gain attributable to distributions of property by a qualified bank holding corporation when received by the shareholder with respect to his stock in such corporation. In addition rules are provided as to the date the qualified bank holding corporation must have acquired the property before it can be distributed with no gain recognized to its shareholders as a result of the distribution. This section also prescribes certain conditions which must be fulfilled before any such distributions of property will obtain the nonrecognition of gain benefits of its provisions.

Subsection (a) of section 1101 provides that a distribution of prohibited property by a qualified bank holding corporation with respect to its stock and without the surrender by the shareholder of any stock or securities in such corporation will not result in any gain being recognized on the receipt of such property by the shareholder if the Board has, before the distribution, certified that the distribution of such property is necessary or appropriate to carry out the first sentence of section 6(a) of the Bank Holding Company Act of 1955. On the date of distribution the distributing corporation must have been a qualified bank holding corporation. The first sentence of section 6(a) provides in general that it shall be unlawful for any bank holding company, after 2 years from the effective date of the Bank Holding Company Act of 1955, to own any shares or other securities or obligations of any company other than a bank or to engage in any business other than that of banking, or of managing or controlling banks, or of the kind of businesses enumerated in section 6(c)(1) of the act. However, such section 6(c) sets forth certain exceptions and permits the holding by a bank holding company of certain types of property.

Subsection (b) of section 1101 applies to a distribution of property by a qualified bank holding corporation, with respect to its stock, to a shareholder without the surrender by the shareholder of stock or securities in such corporation where the Board has before the distribution certified that (1) such property is of a kind which causes such corporation to be a bank holding company, (2) the disposition of property of that kind is necessary to enable such corporation to cease being a bank holding company, and (3) the distribution is necessary or appropriate to effectuate the policies of the Bank Holding Company Act of 1955. In the case of a distribution falling within subsection (b), no gain to the shareholder upon the receipt of such property is to be recognized. Property which is intended to be covered by subsection (b) of section 1101 is that property or properties which is of a kind which causes a company to be a bank holding company within the provisions of section 3(a) of the Bank Holding Company Act of 1955. Thus, assuming that all the conditions of this part are met, a qualified bank holding corporation may distribute to its shareholders without the recognition of gain to them upon such distribution, part or all of the voting shares of one or more of the banks the ownership of which voting shares was the basis upon which such corporation is a bank holding company, if the Board makes the certification required by paragraph (2) of subsection (b). Furthermore, if any corporation was held by the Board to be a bank holding company under clause 2 of section 3(a) of the Bank Holding Company Act, and if such corporation is a qualified bank holding corporation as required by this part, such corporation would be permitted to distribute whatever property it owned upon the basis of which such determination was made by the Board to its shareholders without recognition of the gain on the distribution, if the Board certifies in accord with paragraph (2).

A qualified bank holding corporation which distributes prohibited property with respect to which the Board has certified as required by paragraph (2) of subsection (a), may not have any distributions qualify under subsection (b).

If the first distribution under this part falls under subsection (b), no distribution may qualify under subsection (a). It is the intent of these subsections that a qualified bank holding corporation must determine whether it will dispose of prohibited property and remain a bank holding company or whether it will dispose of the property upon the basis of which the corporation is determined to be a bank holding company.

Subsection (c) of section 1101 is a limitation upon the application of subsections (a) and (b). Subparagraph (A) of paragraph (1) of subsection (c) specifically excludes from the application of subsections (a) and (b) of section 1101 any property which a qualified bank holding corporation acquired after May 15, 1955, except to the extent such corporation received such property (even though subsequent to May 15, 1955) and gain was not recognized by reason of subsection (a) or (b), or unless the property was received by the corporation in exchange for all of its stock in an exchange to which paragraph (2) or (3) of subsection (c) applies.

Under subparagraph (B) of paragraph (1), neither subsection (a) nor (b) of section 1101 is applicable to the distribution by a qualified bank holding corporation of property which was acquired by such corporation in a distribution with respect to stock acquired by it after May 15, 1955, unless such stock was acquired by it (1) in a distribution (with respect to stock held by it on May 15, 1955, or with respect to stock in respect of which all previous applications of this clause are satisfied) with respect to which gain to it was not recognized by reason of subsection (a) or (b) of section 1101, or (2) in exchange for all of its stock in an exchange meeting the requirements of section 1101(c)(2) or (3).

Paragraph (2) of subsection (c) of section 1101 is an exception to the general rule of paragraph (1) of subsection (c) that subsections (a) and (b) do not apply to any property acquired by the distributing corporation after May 15, 1955. Under paragraph (2) if a qualified bank holding corporation exchanges solely property which, under subsection (a), such corporation could distribute directly to its shareholders without the recognition of gain to such shareholders, for all of the stock of a second corporation created and availed of solely for the purpose of receiving such property, and immediately after the exchange, the qualified bank holding corporation distributes all of such stock to its shareholders with respect to its stock, then all of the stock of the second corporation may be distributed to the shareholders of such qualified bank holding corporation without recognition of gain. However, prior to such exchange the Board must certify that the exchange and distribution are necessary or appropriate to effectuate the first sentence of section 6(a) of the Bank Holding Company Act of 1955.

Paragraph (3) of subsection (c) of section 1101 is another exception to the general rule of paragraph (1) of subsection (c) that subsections (a) and (b) do not apply to any property acquired by the distributing corporation after May 15, 1955. Under paragraph (3) if any qualified bank holding corporation exchanges solely property which, under subsection (b), such corporation could distribute directly to its shareholders without the recognition of gain to such shareholders, for all of the stock of a second corporation created and availed of solely for the purpose of receiving such property and immediately after the exchange, the qualified bank holding corporation distributes all of such stock to its shareholders with respect to its stock, then all of the stock of the second corporation may be distributed to the shareholders of such qualified bank holding corporation without the recognition of gain. However, prior to such exchange the Board must have certified that such property is of a kind which causes such corporation to be a bank holding company, that the disposition of property of that kind is necessary to enable such corporation to cease being a bank holding company, and that the exchange and distribution are necessary or appropriate to effectuate the policies of the Bank Holding Company Act of 1955.

Under subsection (d) of section 1101 the nonrecognition of gain provided by subsection (a) or (b) shall not apply to that portion of any distribution which is attributable to any contribution to capital of any corporation made after May 15, 1955. The portion of any distribution which is attributable to a contribution to capital depends upon the particular facts and circumstances of each case.

The preceding paragraph may be illustrated by the following examples. (1) Assume that corporation A (a qualified bank holding corporation) owns all of the stock of corporation X (such stock being property falling within the provi-

sions of subsec. (a) of sec. 1101). Assume further that corporation A, after May 15, 1955, makes a contribution to the capital of corporation X in the amount of $50,000. Thereafter, corporation A makes a distribution to which subsection (a) of section 1101 applies of the stock of corporation X to the shareholders of corporation A. Under subsection (d) the nonrecognition of gain provided by subsection (a) does not apply to that portion of the distribution which is attributable to the contribution of capital, that is, $50,000. The amount of the distribution to the extent of the contribution to capital, $50,000, is a distribution subject to the provisions of section 301 of the Internal Revenue Code of 1954. (2) The facts are the same as in example (1) above, except that the value of the portion of the distribution which is attributable to the contribution to capital, at the time of the distribution, is less than $50,000. The value of that portion of the distribution which is attributable to the contribution to capital of $50,000 is a distribution subject to the provisions of section 301 of the Internal Revenue Code of 1954.

Paragraph (2) of subsection (d), however, provides an exception to the rule established in paragraph (1). Paragraph (2) provides that paragraph (1) shall not apply with respect to any contribution to capital of a bank if the Secretary or his delegate determines that the avoidance of Federal income tax was not one of the principal purposes for making such contributions.

Subsection (e) of section 1101 provides that neither subsection (a) nor subsection (b) shall apply with respect to any distribution by a corporation unless the Board makes the certification required by the subsection.

Paragraph (1) of subsection (e) relates to certification with respect to distributions falling within subsection (a). It provides that subsection (a) shall not apply to any such distribution unless the Board certifies that, before the expiration of the period permitted under section 6(a) of the Bank Holding Company Act of 1955 (including any extensions thereof granted to such corporation under such section 6(a)), the corporation has disposed of all the property, the disposition of which is necessary or appropriate to effectuate the first sentence of such section 6(a) (or would have been so necessary or appropriate if the corporation had continued to be a bank holding company). In order that subsection (a) of section 1101 is to apply to distributions of prohibited property by a qualified bank holding corporation, it is essential that such corporation dispose of all of the property which it is required to dispose of by reason of the Bank Holding Company Act of 1955, within the period (including extensions thereof) specified in section 6(a) of such act. During the period during which such corporation is required to dispose of all such property, distributions of prohibited property are to be considered as being within subsection (a) of section 1101, if other requirements of this part are met. Thus, no gain would be recognized to shareholders on distributions (if such distributions would otherwise qualify for the benefits of this part) during such period. If, at the close of such period, the corporation has disposed of all of the property which it is required to dispose of by the Board and the Board has made the certification required under subsection (e) of section 1101, subsection (a) of section 1101 will apply to distributions of prohibited property. However, if, at the close of such period, the corporation has not disposed of all of the property the disposition of which is necessary or appropriate to effectuate the first sentence of section 6(a) of the Bank Holding Company Act of 1955, then subsection (a) of section 1101 will not apply to any distributions of prohibited property by the corporation. Thus, in a case where the provisions of subsection (e)(1) are not met, the tax treatment of any distribution of prohibited property by a qualified bank holding corporation to its shareholders is governed by the provisions of other sections of the Internal Revenue Code of 1954 applicable thereto.

Paragraph (2) of subsection (e) of section 1101 is applicable to distributions falling within subsection (b) of section 1101. Subparagraph (A) provides that subsection (b) shall not apply unless the Board certifies that the corporation has ceased to be a bank holding company before the expiration of the period specified in subparagraph (B). Under the House bill the period specified in paragraph (B) was 2 years after the date of enactment. Your committee has modified subparagraph (B) to provide that the specified period expires 2 years after the enactment of this part or 2 years after the corporation becomes a bank holding company, whichever is later. Under subparagraph (B) of the House bill the Board is authorized on the application of any qualified bank holding corporation to extend such period from time to time with respect to such corporation for not more than 1 year at a time if, in its judgment, such an extension would not be

detrimental to the public interest, but such period might not be extended beyond the date 5 years after the date of enactment of this part. Your committee has modified this provision to provide that such period may not in any case be extended beyond the date 5 years after the date of enactment of this part or 5 years after the date on which the corporation becomes a bank holding company, whichever is later. The purpose of your committee's changes is to extend the specified periods in the case of corporations which become bank holding companies after the date of enactment of this part by reason of a distribution under section 1101. This treatment makes the specified periods uniform whether such a corporation chooses to distribute prohibited property or bank stock. In order that subsection (b) of section 1101 is to apply to distributions of property of a kind which causes a qualified bank holding corporation to be a bank holding company and the disposition of which is necessary to enable such corporation to cease being a bank holding company, it is essential that such corporation cease to be a bank holding company within the period (including extensions thereof) specified in subsection (e)(2) of section 1101. During the period during which such corporation disposes of property to enable it to cease being a bank holding company, distributions of such property are to be considered as being within subsection (b) of section 1101, if other requirements of this part are met. Thus, no gain would be recognized to shareholders on such distributions (if such distributions would otherwise qualify for the benefits of this part) during such period. If, at the close of such period specified in subsection (e)(2), the corporation has ceased to be a bank holding company, subsection (b) of section 1101 will apply to distributions of such property. However, if, at the close of such period, the corporation has not ceased being a bank holding company, then subsection (b) of section 1101 will not apply to any distributions of such property by the corporation. Thus, in a case where the provisions of subsection (e)(2) are not met, the tax treatment of any distributions of property of a kind which causes a qualified bank holding corporation to be a bank holding company to its shareholders is governed by the provisions of other sections of the Internal Revenue Code of 1954 applicable thereto.

Section 1102 provides special rules for the application of this part.

Subsection (a) relates to the basis of property acquired in distributions under either subsection (a) or subsection (b) of section 1101. If gain is not recognized by reason of either of such subsections with respect to the receipt of any property, then the basis of such property and of the stock with respect to which it was distributed, shall, in the hands of the distributee, be determined by allocating the adjusted basis of such stock between such property and such stock. Such allocation shall be made under regulations prescribed by the Secretary or his delegate.

Subsection (b) of section 1102 of the House bill provided for the extension of the periods of limitation on the assessment and collection of deficiencies in tax arising from distributions to which subsection (a) or (b) of section 1101 apply. Your committee has revised this provision of the House bill in several respects: (1) it has eliminated the extension of the period under section 6502 relating to collection as unnecessary; (2) it has provided that the extension applies to distributions certified by the Board under subsection (a) or (b) of section 1101 in order to correct a technical defect; (3) it has provided that the notification by the corporation be in such manner and with such accompanying information as prescribed in regulations by the Secretary or his delegate; (4) it has provided for a 5-year period after the notification instead of a 1-year period; and (5) it has provided that the notification can only be made after the expiration of the period prescribed in section 6(a) of the Bank Holding Company Act or section 1101(e), whichever is applicable, instead of after a final certification by the Board. Accordingly, under subsection (b) of section 1102 of your committee's bill, the periods of limitation provided in section 6501 (relating to limitations on assessment) shall not expire, with respect to any deficiency (including interest and additions to the tax), resulting solely from the receipt of property by shareholders in a distribution by a qualified bank holding corporation which is certified by the Board under subsection (a) or (b) of section 1101, until 5 years after such corporation notifies the Secretary or his delegate (in such manner and with such accompanying information as the Secretary or his delegate may by regulations prescribe) that the period (including extensions thereof) prescribed in section 6(a) of the Bank Holding Company Act, or section 1101(e), whichever is applicable, has expired. Such assessment may

be made notwithstanding any provisions of law or rule of law which would otherwise prevent such assessment.

Subsection (c) of section 1102 relates to allocation of earnings and profits. In case of any exchange described in section 1101(c)(2) or (3), the earnings and profits of the corporation transferring the property shall be properly allocated between such corporation and the corporation receiving such property under regulations prescribed by the Secretary or his delegate.

Subsection (d) relates to itemization of property distributed. The Board is required in any certification under this part to make such specification and itemization of property as may be necessary to carry out the provisions of this part.

Section 1103 sets forth the definitions, for purposes of this part, of "bank holding company," "qualified bank holding corporation," "prohibited property," "nonexempt property," and "Board."

Subsection (a) of this section provides that the term "bank holding company" means a bank holding company as defined by section 3 of the Bank Holding Company Act of 1955.

Subsection (b) of this section defines the term "qualified bank holding corporation." Your committee has made a technical amendment to subsection (b) in order to make it clear that the tax provisions of this part apply to any corporation as defined in section 7701(a)(3) of the Internal Revenue Code of 1954 if such corporation is a qualified bank holding corporation. In order for a corporation to be a qualified bank holding corporation, and therefore for its shareholders to receive the special tax treatment provided by this part, it must not only be a bank holding company but in addition, it must hold "prohibited property" as defined in subsection (c). For example, if the sole assets of corporation X consist of 25 percent of the voting shares of each of 2 banks, corporation X is not a qualified bank holding corporation.

In addition, to be a qualified bank holding corporation the prohibited property must have been acquired on or before May 15, 1955, by a corporation which is a bank holding company, or must have been acquired in a distribution to it by a qualified bank holding corporation with respect to which gain is not recognized by reason of section 1101 (a). Furthermore, a bank holding company which holds prohibited property acquired by it in exchange for all of its stock in an exchange described in section 1101(c)(2) is a qualified bank holding corporation.

The preceding paragraph may be illustrated by the following examples. (1) If the sole assets of corporation X on May 15, 1955, consist of cash and 25 percent of the voting shares of each of 2 banks and on May 30, 1955, corporation X purchases nonbanking business assets, corporation X is not a qualified bank holding corporation. (2) The sole assets of corporation Y, on May 15, 1955, consist of 25 percent of the voting shares of each of 2 banks and 4 percent of the outstanding voting securities (the value of which is less than 5 percent of the value of corporation Y's total assets) of corporation Z, a qualified bank holding corporation. Corporation Z distributes nonbanking business assets to corporation Y which are prohibited property in the hands of corporation Y, in a distribution to which section 1101 (a) applies. Corporation Y becomes a qualified bank holding corporation by reason of the distribution by Z. (3) On May 15, 1955, corporation B owns all of the stock of corporation A, a qualified bank holding corporation on such date. Corporation B, a qualified bank holding corporation by virtue of its ownership of the stock of corporation A, transfers such stock to corporation C in an exchange meeting the requirements of section 1101(c)(2). Corporation C is a qualified bank holding corporation.

Notwithstanding that a corporation meets the requirements of paragraph (1) of subsection (b), such corporation shall not be a qualified bank holding corporation unless it meets the additional requirements of subparagraphs (A), (B), and (C) of paragraph (2).

Subparagraph (A) of paragraph (2) provides that a bank holding company shall not be a qualified bank holding corporation unless such corporation would have been a bank holding company on May 15, 1955, if the Bank Holding Company Act of 1955 had been in effect on such date, or unless such corporation is a bank holding company determined solely by reference to the following: (1) Property acquired by such corporation on or before May 15, 1955; (2) property acquired by such corporation in a distribution by a qualified bank holding corporation to such corporation wherein gain was not recognized by reason of subsection (a) or (b) of section 1101; and (3) property acquired by such corpora-

tion in exchange for all of its stock in an exchange meeting the requirements of section 1101(c) (2) or (3).

Thus, if on May 15, 1955, the sole assets of corporation X consist of cash and business assets and on May 30, 1955, corporation X acquires 25 percent of the voting shares of each of 2 banks for cash, then, by reason of subparagraph (A) of paragraph (2), corporation X, although a bank holding company, holding prohibited property acquired by it before May 15, 1955, is not a qualified bank holding corporation. An additional example of the application of subparagraph (A) of paragraph (2) is where corporation X is determined, by the Board, after May 15, 1955, to be a bank holding company by reason of clause (2) of section 3(a) of the Bank Holding Company Act of 1955, solely by reference to (1) property acquired by such corporation on or before May 15, 1955, and (2) property acquired by it from a qualified bank holding corporation in a distribution in which gain to the distributee was not recognized by reason of subsection (a) or (b) of section 1101.

Except as explained in the next paragraph, subparagraph (B) of paragraph (2) provides that a bank holding company shall not be a qualified bank holding corporation by reason of either (1) the acquisition by such bank holding company of prohibited property after May 15, 1955, in a distribution from a qualified bank holding corporation to which section 1101(a) is applicable or (2) the acquisition by such bank holding company (which company would not have been a bank holding company on May 15, 1955, if the Bank Holding Company Act of 1955 had been in effect on such date) of property described in clause (ii) of subparagraph (A) of paragraph (2). An example of the operation of the foregoing is where, on May 15, 1955, the sole assets of corporation Y consist of cash and 25 percent of the voting shares of each of two banks. On May 30, 1955, corporation Y purchases for cash 50 percent of the stock of corporation Z, a qualified bank holding corporation. Corporation Z distributes business assets to corporation Y in a distribution in which gain to corporation Y with respect to the receipt of such property was not recognized by reason of section 1101(a). Corporation Y is not a qualified bank holding corporation since such property was acquired by corporation Y in a distribution with respect to stock acquired after May 15, 1955.

A bank holding company may be a qualified bank holding corporation by reason of the property described in the preceding paragraph if such property was acquired in a distribution with respect to stock which was acquired by such company (1) on or before May 15, 1955, (2) in a distribution (with respect to stock held by it on May 15, 1955, or with respect to stock in respect of which all previous applications of this clause are satisfied) with respect to which gain to it was not recognized by reason of subsection (a) or (b) of section 1101, or (3) in exchange for all of the stock of the bank holding company in an exchange meeting the requirements of section 1101(c)(2) or (3).

Subparagraph (C) of paragraph (2) states that a corporation may not be treated as a qualified bank holding corporation unless the Board certifies that it satisfies the requirements of subsection (b) of section 1103.

Subsection (c) of section 1103 defines the term "prohibited property." Such property is defined as property, other than nonexempt property, the disposition of which, in the case of any bank holding company, would be necessary or appropriate to effectuate the first sentence of section 6(a) of the Bank Holding Company Act of 1955, if such company continued to be a bank holding company beyond the period (including any extensions thereof) specified in section 6(a), in the case of distributions under section 1101(a), or specified in section 1101(e)(2)(B), in the case of distributions under section 1101(b). The term "prohibited property" does not include shares, securities, or obligations of any company which are held by a bank holding company to the extent that the ownership by such bank holding company of such property is not prohibited by section 6 of such act by reason of subsection (c)(6) of such section.

Subsection (d) defines the term "nonexempt property," the distribution of which may not be accorded the tax treatment provided by this part.

Subsection (e) of this section states that the term "Board" means the Board of Governors of the Federal Reserve System.

Section 10(b) amends table of parts of chapter 1, subchapter O of Internal Revenue Code of 1954 by adding "Part VIII. Distributions pursuant to Bank Holding Company Act of 1955."

Section 10(c) makes these tax provisions in section 10(a) apply to taxable years ending after the enactment of the act.

[S. 2577—P. L. 511]

CONTROL OF BANK HOLDING COMPANIES

[Senate Report No. 1095, Part 2, Eighty-fourth Congress, Second Session. Calendar No. 1107] [2]

[March 6, 1956]

Mr. Robertson, from the Committee on Banking and Currency, reported the following additional amendments to accompany the bill S. 2577, heretofore reported.

The Committee on Banking and Currency, having heretofore considered and reported the bill (S. 2577) to define bank holding companies, control their future expansion, and require divestment of their nonbanking interests, hereby report certain additional amendments, with an accompanying report, and recommend their adoption.

On July 25, 1955, the committee reported the bill (S. 2577) to define bank holding companies, control their future expansion, and require divestment of their nonbanking interests. Since the bill was reported out during the closing days of the 1st session of the 84th Congress, it was understood that the bill would not be acted upon by the Senate until the 2d session of the 84th Congress. The interim period provided an opportunity for the Members of the Senate, representatives of bank holding companies, and other interested persons to study the proposed legislation and determine if any perfecting amendments were necessary. As a result of the study, the committee has agreed to a number of technical and clarifying amendments and amendments to the tax provisions of the bill.

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LABOR, AGRICULTURAL OR HORTICULTURAL ORGANIZATIONS

Section 4 (c) (7) of the bill as reported contains an exemption from the divestment requirements for any bank holding company which is a labor, agricultural or horticultural organization. Although the committee report points out that in order to be entitled to this exemption no net income derived by any such organization can inure to the benefit of any individual, this limitation is not set forth in the language of the subsection. The intention of the committee is made explicit by inserting at the end of the subsection on line 15, page 11, the words "and which is exempt from taxation under section 501 of the Internal Revenue Code of 1954."

FOREIGN BANKING SUBSIDIARIES

Section 2(c) of the bill as reported defines "bank" so as to exclude any organization which does not do business within the United States. Thus, technically any foreign banking subsidiary of a bank holding company would be a nonbanking investment and would be required to be divested pursuant to section 4(a) of the bill. The Federal Reserve Board would probably exempt such foreign banking subsidiaries from divestment by applying the provisions of section 4(c)(6), which authorizes the Board to exempt companies of a financial nature which are so closely related to the business of banking as to be a proper incident thereto.

However, in order to make it unmistakably clear that foreign banking subsidiaries are not subject to divestment, the committee added a new subparagraph (8) to section 4(c) specifically exempting such subsidiaries. The amendment provides that the divestment requirements shall not apply—

> to shares held or acquired by a bank holding company in any company which is organized under the laws of a foreign country and which is engaged principally in the banking business outside the United States.

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[2] This publication of the Committee Report is restricted to excerpts involving internal revenue matters.

TAX AMENDMENTS

General Explanation

H. R. 6227, passed by the House of Representatives, would add a new part VIII to subchapter O of the Internal Revenue Code of 1954. Under this new part, several tax-free paths are provided for the divestment of property which this bill imposes on a bank holding company. S. 2577, as originally reported, adopted the tax provisions of the House bill with certain technical changes. Your committee's additional amendments modify these tax provisions so as to prevent abuse and to make them more flexible to meet legitimate business needs by alining them closer to similar provisions in the Internal Revenue Code of 1954.

In general, a corporation which comes within the terms of the bill as a bank holding company can choose between remaining a bank holding company or disposing of its interests in banks. The tax provisions of the bill apply only to a corporation which would have been a bank holding company on May 15, 1955, and which on that date held prohibited property.

If a corporation decides to remain a bank holding company, subject to the supervision of the Federal Reserve Board, it may distribute any prohibited property, which the Board certifies is necessary or appropriate to comply with the bill, to its shareholders without the recognition of gain by the shareholders. For this purpose prohibited property, in general, means stock or assets of nonbanking businesses to the extent the bank holding company is required to divest itself of such assets under section 4 of the bill. The term does not include cash, Government bonds, or certain short-term obligations. It is believed desirable to expressly exclude cash, and so forth, from the definition of prohibited property, since a similar exclusion is contained in the comparable provisions of part VI of subchapter O, relating to exchanges in obedience to SEC orders.

With respect to the distributing corporation, the usual provisions of the Internal Revenue Code of 1954 apply. Under these provisions, gain generally is not recognized to the distributing corporation except under unusual circumstances such as the distribution of LIFO inventory, the distribution of property subject to a liability in excess of the adjusted basis, or the distribution of certain installment obligations.

The distribution of prohibited property may be made either directly to the shareholders of the corporation which is a bank holding company or may be transferred to a wholly owned subsidiary expressly created for purposes of receiving the prohibited property, in which case all of the shares in the new corporation must be distributed directly to shareholders. Under the bill prohibited property may be placed in one or more such new corporations. Your committee's amendments differ from S. 2577, as originally reported, by providing that other assets may also be transferred to a new corporation without making the transaction taxable. This would include cash and bonds, for working capital purposes, as well as prohibited property acquired after May 15, 1955, but not controlling shares of bank stock or similar property.

Your committee's amendments also differ from S. 2577, as originally reported, by providing that the tax exemption for any particular distribution may be denied if that distribution is part of a plan with a principal purpose of avoiding dividend tax on a distribution of earnings and profits.

Your committee's amendments also differ from S. 2577, as originally reported, by making provisions for certain exchanges of stocks and bonds as part of the divestment program. Under S. 2577, as originally reported, bank holding companies having outstanding preferred stocks and bonds might encounter serious obstacles in making use of the tax provisions of the bill. The divestments required under the general provisions of the bill would remove from the corporation property that provides security for its preferred stocks or bonds. Your committee's amendments would permit the exchange of preferred stocks and bonds in the old corporation for comparable securities in the new corporations or direct distribution of prohibited property in exchange for the outstanding preferred stocks or bonds.

The bill provides that in exchanges involving the creation of a subsidiary a common shareholder may only receive common stock, a preferred shareholder may only receive preferred stock issued on substantially the same terms or common stock, and, finally, a bondholder may receive only bonds issued on substantially the same terms, or preferred or common stock. It is also provided that a bondholder in such an exchange may be taxable on any greater face value of bonds received over those given up.

If a corporation which is a qualified bank holding company under the bill chooses to divest itself of all or part of any stock or property which causes it to be a bank holding company, it may distribute directly to its shareholders or bondholders such stock or property, or it may form a subsidiary to effectuate such distribution. Your committee has made the same revisions for divestments of this type as are made in the case of divestments of prohibited property.

The Board must certify that the divestment of the bank stock or similar property is necessary or appropriate to effectuate the policies of the bill. In the case of direct distributions, for example, the corporation may distribute to its shareholders without the recognition of gain all the shares of bank stock in a bank in which it was deemed to have control within the meaning of section 2(a) of the bill. Thus, if a corporation owned 40 percent of the voting stock of each of two banks, it could distribute all of its shares in those banks even though it ceased to be a bank holding company by distributing only 16 percent of the voting shares in one bank. If the same corporation had in addition 15 percent of the voting shares of a third bank, it would not be able to distribute tax free, under this bill, those voting shares unless the Federal Reserve Board deemed that by virtue of those shares the corporation exercised an effective control over the election of a majority of the board of directors of the particular bank.

Your committee contemplates that the Federal Reserve Board, in the discharge of its functions in making certifications that exchanges and distributions are necessary or appropriate to effectuate the purposes of the bill, will examine these from the point of view of their desirability from a banking standpoint. However, a certification by the Board that a particular divestment is necessary or appropriate is not to be considered as permitting any method of carrying out this divestment if it is part of a plan having a principal purpose of avoiding dividend tax on a distribution of earnings and profits.

In case of direct distributions to stockholders and bondholders of either prohibited property or property which causes the distributing corporation to be a bank holding company, your committee has restricted the nonrecognition treatment to property which was owned on May 15, 1955. This restriction is deemed necessary to prevent corporations from purchasing highly marketable shares and other property as a means of transferring cash from the corporation to its shareholders. The restriction would not apply, however, if the property were received in a transaction in which gain was not recognized because of either the general rules described above or in certain types of corporate reorganizations or liquidations. For example, if prohibited property originally acquired prior to May 15, 1955, were distributed by a subsidiary to its parent in a corporate chain without recognition of gain to the parent by reason of provisions in this bill, the parent, in turn, may distribute the property to its own shareholders without recognition of gain under a certification by the Board, even though the property was acquired by the parent after May 15, 1955. Similarly, the May 15, 1955, cutoff date is not applicable where the prohibited property or controlling bank interests certified by the Board are retained at the corporate level by the transfer to a wholly owned subsidiary created for that purpose if stock of the subsidiary is distributed by the qualified bank holding company, and such distribution meets the tax avoidance test discussed previously. In the case of the creation of a subsidiary, prohibited property or controlling bank stock acquired after May 15, 1955, may be transferred to it along with prohibited property or controlling bank stock acquired prior to May 15, 1955.

In the case of a contribution to capital of any corporation made by a bank holding company after the date of enactment of this bill, the general test of a principal purpose of tax avoidance will be applied. Where a contribution has been made after May 15, 1955, and before the date of enactment under the terms described in the bill, the treatment provided in S. 2577, as originally reported, will be retained. If any part of the contribution made in this period is part of a plan for the avoidance of taxes, only a portion of the shares of the corporation to which the contribution is made will be taxable on distribution. This portion will correspond to the portion of the value of those shares attributable to the contribution.

Where the nonrecognition treatment has been extended to prohibited property which has been distributed by the corporation which is a bank-holding company, a final certification must be obtained from the Board that the corporation has divested itself of all property necessary or appropriate to comply with the bill within the statutory period permitted for divestment. If this final certification is not obtained, the transactions previously permitted to be made without recognition of gain are reopened and tax may be imposed in such cases. For this

purpose the statute of limitations on assessment of deficiency resulting solely from the distribution of prohibited property which has been certified by the Board does not expire until 5 years after the corporation gives notification that the period prescribed in section 4(a) of the bill has expired.

A similar final certification is required where nonrecognition treatment has been originally accorded to the distribution of bank stock or similar property which the Board has certified that the corporation must divest in order to cease being a bank-holding company. In this case the tax provisions of the bill provide that the Board must give a final certification that the corporation has ceased to be a bank-holding company within 2 years after the date of enactment of the bill or within 2 years after the date on which the corporation becomes a bank-holding company, whichever is later, unless the time has been extended by the Board for 1-year renewals not to exceed 5 years from the date of enactment of the bill or the date on which the corporation becomes a bank-holding company, whichever is later. The statutory period for the assessment of a deficiency resulting solely from such distribution is extended in the same manner as in the case of the distribution of prohibited property.

The basis of stock or other property received by a distributee without recognition of gain under the provisions of the bill is determined by allocating the adjusted basis of the stock with respect to which the distribution is made between such stock and the property so distributed. In the case of any recognition of gain upon the receipt of stock or property, such gain will be taken into account in determining the adjusted basis of the stock with respect to which the distribution was made and the property which was received. These rules are similar to the general rules for allocation of basis in the case of stock dividends and corporate reorganizations. The bill provides that the allocation of basis shall be made under regulations provided by the Secretary or his delegate.

Where a bank holding company distributes stock or a subsidiary formed to receive either prohibited property or controlling bank interests which causes it to be a bank holding company, proper allocation of the earnings and profits of the bank holding company is made to the subsidiary. Your committee has extended such treatment to direct distributions of stock of a corporation where the bank holding company owns at least 80 percent of such corporation.

Except in the case of a distribution permitted to be made tax free under this part, nothing in this bill is intended to limit the applicability of other provisions of the Internal Revenue Code of 1954. For example, in a program of divestments under this bill a bank holding company, could make distributions permitted under the tax provisions of this bill or under subchapter C of chapter 1 of the Internal Revenue Code of 1954 (relating to corporate distributions and adjustments).

DETAILED DISCUSSION

Section 10 of S. 2577, as reported by your committee, amends subchapter O of chapter 1 of the Internal Revenue Code of 1954 by adding a new part VIII. This part VIII specifies the extent to which (during a transition period after the enactment of the bill) gain will not be recognized upon receipt of property by a shareholder of a bank holding company, if such distribution is made pursuant to a certification by the Board of Governors of the Federal Reserve System that such distribution is necessary or appropriate to effectuate the Bank Holding Company Act of 1956. The provisions of the new part VIII are restricted by their own terms to the gain directly attributable to the receipt of property in the distributions specifically described.

The rules contained in part VIII are in addition to the other provisions of subtitle A of the Internal Revenue Code of 1954 (such as provisions relating to the recognition or nonrecognition of gain to a corporation making distributions, the provisions under which tax-free reorganizations may be effectuated, etc.). Many of these other provisions are contained in subchapter C of chapter 1 of such code (relating to corporate distributions and reorganizations). The provisions of part VIII supersede the other provisions of chapter 1 only in the cases qualifying under part VIII, and in those cases only to the extent specific provision is contained in part VIII. Accordingly, where the distribution to the shareholders of a bank holding company of 100 percent of the stock of another corporation meets the requirements of section 355 of the Internal Revenue Code of 1954, no gain or loss is recognized to such shareholders notwithstanding the fact that, under the provisions contained in part VIII, nonrecognition of gain

or loss would not be granted, in some cases, with respect to 5 percent of such stock.

The additional amendments of your committee make certain changes in the tax provisions of the bill.

Section 1101 sets forth the conditions for nonrecognition of gain attributable to distributions of property by a qualified bank holding corporation when received by the shareholder with respect to his stock in such corporation. In addition rules are provided as to the date the qualified bank holding corporation must have acquired the property before it can be distributed with no gain recognized to its shareholders as a result of the distribution. This section also prescribes certain conditions which must be fulfilled before any such distributions of property will obtain the nonrecognition of gain benefits of its provisions.

The additional amendments of your committee revise subsection (a) of section 1101 in several respects: (1) Distributions of prohibited property consisting of stock received in an exchange to which section 1101(c)(2) applies are treated separately from all other distributions of prohibited property; (2) provision is made for the nonrecognition of gain to certain shareholders and security holders on certain exchanges; and (3) it is specifically provided that nonrecognition treatment may be available whether or not a distribution is pro rata.

Section 1101(a)(1) provides that a distribution of prohibited property, other than stock received in an exchange to which section 1101(c)(2) applies, by a qualified bank holding corporation with respect to its stock and without the surrender by the shareholders of any stock in such corporation will not result in any gain being recognized on the receipt of such porperty by the shareholders if the Board has, before the distribution, certified that the distribution of such property is necessary or oppropriate to carry out section 4 of the Bank Holding Company Act of 1956. Furthermore, under your committee's amendments, the qualified bank holding corporation may distribute such property to a shareholder in exchange for its preferred stock or to a security holder in exchange for its securities if the Board has certified that the distribution of such property is necessary or appropriate to carry out section 4 of the Bank Holding Company Act of 1956. On the date of distribution the distributing corporation must have been a qualified bank holding corporation. Section 4 provides in general that it shall be unlawful for any bank holding company, after 2 years from the date of enactment of the Bank Holding Company Act of 1956, to own any voting shares of any company other than a bank or a bank holding company or to engage in any business other than that of banking or of managing or controlling banks or of furnishing services to or performing services for any bank of which it owns or controls 25 percent or more of the voting shares. However, section 4(c) sets forth certain exceptions and permits the holding by a bank holding company of certain types of property.

Section 1101(a)(2) of your committee's bill provides for the tax treatment of certain distributions of stock and securities received in an exchange to which section 1101(c)(2) applies. A distribution of common stock received in an exchange to which section 1101(c)(2) applies may be made by a qualified bank holding corporation to its shareholders (both common and preferred), with or without the surrender by such shareholders of their stock, without the recognition of any gain to the shareholders. Shareholders owning common stock in the distributing corporation may not receive preferred stock received in an exchange to which section 1101(c)(2) applies with respect to their common stock without recognition of gain, whether or not they surrender common stock. Nor may shareholders owning preferred stock in the distributing corporation receive preferred stock obtained in an exchange to which section 1101(c)(2) applies without recognition of gain without surrender of preferred stock. Similarly, in no case may security holders receive common stock, preferred stock, or securities received in an exchange to which section 1101(c)(2) applies without recognition of gain without the surrender of securities. Preferred stock or common stock, or both, received in an exchange to which section 1101(c)(2) applies may be distributed by a qualified bank holding corporation to shareholders owning preferred stock in exchange for their preferred stock without the recognition of gain if the preferred stock received (if any) has substantially the same terms as the preferred stock surrendered. Either common or preferred stock, or both, received in an exchange to which section 1101(c)(2) applies may be distributed by a qualified bank holding corporation to its security holders, in exchange for their securities, without any recognition of gain to the security holders. A qualified bank holding corporation may also distribute securities received in an exchange to which subsection (c)(2) of section 1101 applies in

exchange for its securities, without recognition of gain to the security holders, if the securities received have substantially the same terms as the securities surrendered. However, if the principal amount of the securities received by the security holder is greater than the principal amount of the securities surrendered, the excess principal amount does not receive nonrecognition treatment under section 1101(a). In the case of any exchange of stock or securities of the distributing corporation it is not necessary that all of the stock or securities held by the distributee be surrendered.

A distribution may be entitled to nonrecognition treatment, with respect to shareholders, under paragraphs (1) or (2) of section 1101(a) whether or not the distribution is pro rata with respect to all of the shareholders of the qualified bank holding corporation.

Section 1101(b) deals with distributions in the case of a corporation ceasing to be a bank holding company. As in the case of subsection (a), the additional amendments of your committee revise subsection (b) of section 1101 in several respects: (1) Distributions of stock received in an exchange to which section 1101(c)(3) applies are treated separately from all other distributions of property which cause a corporation to be a bank holding company; (2) provision is made for the nonrecognition of gain to certain shareholders and security holders on certain exchanges; and (3) it is specifically provided that nonrecognition treatment may be available whether or not a distribution is pro rata. In order to provide greater clarity, your committee has also revised the description in section 1101(b)(1)(B) of property causing a corporation to be a bank holding company.

Section 1101(b)(1) applies to a distribution of property, other than stock received in an exchange to which section 1101(c)(3) applies, by a qualified bank holding corporation, with respect to its stock, to a shareholder without the surrender by such shareholder of stock in such corporation where the Board has before the distribution certified that (1) such property is all or part of the property by reason of which such corporation controls within the meaning of section 2(a) a bank or a bank holding company, or that such property is part of the property by reason of which such corporation did control a bank or a bank holding company before any property of the same kind was distributed under section 1101(b) or exchanged under section 1101(c)(3), and (2) the distribution is necessary or appropriate to effectuate the policies of the Bank Holding Company Act of 1956. Under your committee's amendment, the qualified bank holding corporation may also distribute such property to a shareholder in exchange for its preferred stock or to a security holder in exchange for its securities if the Board has made a similar certification. In the case of a distribution falling within subsection (b), no gain to the shareholder or security holder upon the receipt of such property is recognized. Property which is intended to be covered by section 1101(b)(1) is that property or properties which is of a kind which causes a company to be a bank holding company within the provisions of section 2(a) of the Bank Holding Company Act of 1956. Thus, assuming that all the conditions of this part are met, a qualified bank holding corporation may distribute to its shareholders without the recognition of gain to them upon such distribution, part or all of the voting shares of one or more of the banks the ownership of which voting shares was the basis upon which such corporation is a bank holding company, if the Board makes the certification required by section 1101(b)(1)(B). Furthermore, if any corporation was held by the Board to be a bank holding company under clause (2) of section 2(a) of the Bank Holding Company Act, and if such corporation is a qualified bank holding corporation as required by this part, such corporation would be permitted to distribute whatever property it owned upon the basis of which such determination was made by the Board to its shareholders without recognition of the gain on the distribution, if the Board certifies in accord with section 1101(b)(1)(B).

Section 1101(b)(2) of your committee's bill provides for the tax treatment of certain distributions of stock and securities received in an exchange to which section 1101(c)(3) applies. A distribution of common stock received in an exchange to which section 1101(c)(3) applies may be made by a qualified bank holding corporation to its shareholders (both common and preferred), with or without the surrender by such shareholders of their stock, without the recognition of any gain to the shareholders. Shareholders owning common stock in the distributing corporation may not receive preferred stock received in an exchange to which section 1101(c)(3) applies with respect to their common stock without recognition of gain, whether or not they surrender common stock.

Nor may shareholders owning preferred stock in the distributing corporation receive preferred stock obtained in an exchange to which section 1101(c)(3) applies without recognition of gain without surrender of preferred stock. Similarly, in no case may security holders receive common stock, preferred stock, or securities received in an exchange to which section 1101(c)(3) applies without recognition of gain without the surrender of securities. Preferred stock or common stock, or both, received in an exchange to which section 1101(c)(3) applies may be distributed by a qualified bank holding corporation to shareholders owning preferred stock in exchange for their preferred stock without the recognition of gain if the preferred stock received (if any) has substantially the same terms as the preferred stock surrendered. Either common or preferred stock, or both, received in an exchange to which section 1101(c)(3) applies may be distributed by a qualified bank holding corporation to its security holders, in exchange for their securities without any recognition of gain to the security holders. A qualified bank holding corporation may also distribute securities received in an exchange to which subsection (c)(3) of section 1101 applies in exchange for its securities, without recognition of gain to the security holders, if the securities received have substantially the same terms as the securities surrendered. However, if the principal amount of the securities received by the security holder is greater than the principal amount of the securities surrendered, the excess principal amount does not receive nonrecognition treatment under section 1101(b). In the case of any exchange of stock or securities of the distributing corporation it is not necessary that all of the stock or securities held by the distributee be surrendered.

A distribution may be entitled to nonrecognition treatment, with respect to shareholders, under paragraphs (1) or (2) of section 1101(b) whether or not the distribution is pro rata with respect to all of the shareholders of the qualified bank holding corporation.

It is the intent of the bill that a qualified bank holding corporation must determine whether it will dispose of prohibited property and remain a bank holding company or whether it will dispose of the property upon the basis of which the corporation is determined to be a bank holding company. Therefore, section 1101(a)(4) and (b)(4) provide that if the first distribution under this part qualities for nonrecognition treatment under subsection (a) no distribution may qualify under subsection (b). Similarly, if the first distribution under this part qualifies for nonrecognition treatment under subsection (b) no distribution may qualify under subsection (a).

Subsection (c) of section 1101 is a limitation upon the application of subsections (a) and (b). Subparagraph (A) of paragraph (1) of subsection (c) specifically excludes from the application of subsections (a) and (b) of section 1101 any property which a qualified bank holding corporation acquired after May 15, 1955, except to the extent such corporation received such property (even though subsequent to May 15, 1955) and (1) gain was not recognized by reason of subsection (a) or (b), or (2) the property was received by the corporation in exchange for all of its stock in an exchange to which paragraph (2) or (3) of subsection (c) applies, or (3) such property was acquired by the distributing corporation in a transaction in whic gain was not recognized under section 305 (a) or section 332, or under section 354 by reason of a reorganization described in section 368(a)(1)(E) or (F) (recapitalization or mere change in identity, form, or place of organization).

Under subparagraph (B) of paragraph (1), neither subsection (a) nor (b) of section 1101 is applicable to the distribution by a qualified bank holding corporation of property which was acquired by such corporation in a distribution with respect to stock acquired by it after May 15, 1955, unless such stock was acquired by it (1) in a distribution (with respect to stock held by it on May 15, 1955, or with respect to stock in respect of which all previous applications of this clause are satisfied) with respect to which gain to it was not recognized by reason of subsection (a) or (b) of section 1101, or (2) in exchange for all of its stock in an exchange meeting the requirements of section 1101(c)(2) or (3), or (3) in a transaction in which gain was not recognized under section 305(a) or section 332, or under section 354 by reason of a reorganization described in section 368 (a)(1)(E) or (F).

Paragraphs (2) and (3) of subsection (c) of section 1101 are exceptions to the general rule of paragraph (1) of subsection (c) that subsections (a) and (b) do not apply to any property acquired by a distributing corporation after May 15, 1955. In general paragraphs (2) and (3) permit the distribution of the stock and securities of corporations organized to receive property which

could have been distributed directly. Under the tax provisions of S. 2577 as originally reported by your committee, the corporation organized under these paragraphs could receive only property which could have been distributed directly without recognition of gain to shareholders. The amendments proposed by your committee permit the transfer of additional property (including cash) when there is not a plan to avoid Federal income tax.

Under subparagraph (C) of paragraph (1), neither subsection (a) nor (b) of section 1101 is applicable to the distribution by a qualified bank holding corporation of property acquired by such corporation in a transaction in which gain was not recognized under section 332, unless such property was acquired from a corporation which, if it had been a qualified bank holding corporation, could have distributed such property under section 1101(a)(1) or (b)(1).

Under paragraph (2) if a qualified bank holding corporation exchanges property which, under subsection (a)(1), such corporation could distribute directly to its shareholders or security holders without the recognition of gain to such shareholders or security holders and other property (except property described in section 1101(b)(1)(B)(i)) for all of the stock of a second corporation created and availed of solely for the purpose of receiving such property, and immediately after the exchange, the qualified bank holding corporation distributes all of such stock in a manner prescribed in section 1101(a)(2)(A), then the stock and securities of the second corporation may be distributed to the shareholders and security holders of such qualified bank holding corporation in distributions meeting the requirements of section 1101(a)(2). However, prior to such exchange, the Board must certify, with respect to the property exchanged consisting of property which the corporation could have distributed directly to its shareholders or security holders without recognition of gain under section 1101(a)(1), that the exchange and distribution are necessary or appropriate to effectuate section 4 of the Bank Holding Company Act of 1956.

Under paragraph (3) of section 1101(c) if any qualified bank holding corporation exchanges property which it could have distributed directly to its shareholders or security holders without recognition of gain to them under section 1101(b)(1) and other property (except prohibited property), for all of the stock of a second corporation created and availed of solely for the purpose of receiving such property, and immediately after the exchange the qualified bank holding corporation distributes all of such stock in a manner prescribed in section 1101(b)(2)(A), then the stock and securities of the second corporation may be distributed to the shareholders and security holders of such qualified bank holding corporation in distributions meeting the requirements of section 1101(b)(2). However, prior to such exchange the Board must have certified, with respect to the property exchanged consisting of property which the corporation could have distributed directly to its shareholders or security holders without recognition of gain under section 1101(b)(1), that (1) such property is all or part of the property by reason of which such corporation controls within the meaning of section 2(a) a bank or a bank holding company, or that such property is part of the property by reason of which the corporation did control a bank or a bank holding company before any property of the same kind was distributed under section 1101(b)(1) or exchanged under section 1101(c)(3), and (2) the exchange and distribution are necessary and appropriate to effectuate the policies of the Bank Holding Company Act of 1956.

An exchange will meet the requirements of section 1101(c)(2) or (3) even though the only property transferred by the qualified bank holding corporation is property which could have been distributed to its shareholders or security holders directly without the recognition of gain to them. However, the distribution of the stock and securities of the corporation receiving such property will not receive the nonrecognition treatment provided in sections 1101(a) and (b) if property of the type referred to in section 1101(d) is retained in pursuance of a plan to avoid Federal income tax. The qualified bank holding corporation making an exchange under section 1101(c)(2) or (3) may receive securities of the second corporation in addition to all of the stock of such corporation. However, the securities received may be distributed without recognition of gain only to the extent provided in section 1101 (a)(2) and (b)(2).

Your committee has amended the tax provisions of S. 2577, as originally reported, to provide, in section 1101 (d), that distributions which are a part of a plan to avoid Federal income tax will not qualify for nonrecognition treatment under sections 1101 (a) and (b). This amendment to the bill adopts an approach analogous to that used in section 355(a)(1)(B) of the Internal Revenue Code of 1954. This amendment is applicable both to direct distributions of

property and to distributions of the stock and securities received in an exchange to which section 1101(c) (2) or (3) applies. Paragraph (1) of section 1101(d) provides that section 1101(a) shall not apply to a distribution of nonbanking property if, in connection with such distribution, the distributing corporation retains, or transfers after May 15, 1955, to any corporation, property (other than prohibited property) as part of a plan one of the principal purposes of which is the distribution of the earnings and profits of any corporation. Similarly, paragraph (2) of section 1101(d) provides that section 1101(b) shall not apply to a distribution of banking property if, in connection with such distribution, the distributing corporation retains, or transfers after May 15, 1955, to any corporation property (other than property described in sec. 1101(b)(1)(B)(i)) as part of a plan one of the principal purposes of which is the distribution of the earnings and profits of any corporation.

Your committee has adopted an amendment providing a special rule for contributions to capital of a corporation made after May 15, 1955, and prior to the date of enactment. Paragraph (3) of section 1101(d) provides that in a case of a distribution a portion of which is attributable to a transfer which is a contribution to the capital of a corporation, made after May 15, 1955, and prior to the date of enactment, if section 1101 (a) or (b) would apply to such distribution but for the fact that such contribution to capital is part of a tax avoidance plan under paragraph (1) or (2) of section 1101(d), then, notwithstanding paragraph (1) or (2) of subsection (d), section 1101 (a) or (b) shall apply to that portion of such distribution not attributable to such contribution to capital and shall not apply to that portion attributable to such contribution to capital.

The preceding paragraph may be illustrated by the following examples:

(1) Assume that corporation A (a qualified bank holding corporation) owns all of the stock of corporation X. Assume further that corporation A, after May 15, 1955, and prior to the date of the enactment of this bill, makes a contribution to the capital of corporation X in the amount of $50,000 in pursuance of a plan to avoid Federal income tax under paragraph (1) or (2) of section 1101 (d). Thereafter, corporation A makes a distribution of the stock of corporation X to the shareholders of corporation A which would be entitled to nonrecognition treatment but for the tax avoidance plan. Under subsection (d) the nonrecognition of gain provided by subsection (a) does not apply to that portion of the distribution which is attributable to the contribution of capital, that is, $50,000. The amount of the distribution to the extent of the contribution to capital, $50,000, is a distribution subject to the provisions of section 301 of the Internal Revenue Code of 1954.

(2) The facts are the same as in example (1) above, except that the value of the portion of the distribution which is attributable to the contribution to capital, at the time of the distribution, is less than $50,000. The value of that portion of the distribution which is attributable to the contribution to capital of $50,000 is a distribution subject to the provisions of section 301 of the Internal Revenue Code of 1954.

Subsection (e) of section 1101 provides that neither subsection (a) nor subsection (b) shall apply with respect to any distribution by a corporation unless the board makes the certification required by the subsection.

Paragraph (1) of subsection (e) relates to certification with respect to distributions falling within subsection (a). It provides that subsection (a) shall not apply to any such distribution unless the Board certifies that, before the expiration of the period permitted under section 4(a) of the Bank Holding Company Act of 1956 (including any extensions thereof granted to such corporation under such sec. 4(a)), the corporation has disposed of all the property, the disposition of which is necessary or appropriate to effecuate section 4 (or would have been so necessary or appropriate if the corporation had continued to be a bank holding company). In order that subsection (a) of section 1101 is to apply to distributions of property by a qualified bank holding corporation, it is essential that such corporation dispose of all of such property within the period (including extensions thereof) specified in section 4(a) of such act. During the period during which such corporation is required to dispose of all such property, distributions of property are to be considered as being within subsection (a) of section 1101, if other requirements of this part are met. Thus, no gain would be recognized to shareholders on distributions (if such distributions would otherwise qualify for the benefits of this part) during such period. If, at the close of such period, the corporation has disposed of all of such property and the Board has made the certification required under

subsection (e) of section 1101, subsection (a) of section 1101 will apply to distributions of property. However, if, at the close of such period, the corporation has not disposed of all of the property the disposition of which is necessary or appropriate to effectuate section 4 of the Bank Holding Company Act of 1956, then subsection (a) of section 1101 will not apply to any distributions of property by the corporation. Thus, in a case where the provisions of subsection (e)(1) are not met, the tax treatment of any distribution of property by a qualified bank holding corporation to its shareholders is governed by the provisions of other sections of the Internal Revenue Code of 1954 applicable thereto.

Paragraph (2) of subsection (e) of section 1101 is applicable to distribution falling within subsection (b) of section 1101. Subparagraph (A) provides that subsection (b) shall not apply unless the Board certifies that the corporation has ceased to be a bank holding company before the expiration of the period specified in subparagraph (B). Under H. R. 6227 the period specified in paragraph (B) was 2 years after the date of enactment. S. 2577, as originally reported, modified subparagraph (B) to provide that the specified period expires 2 years after the enactment of this part or 2 years after the corporation becomes a bank holding company, whichever is later. Under subparagraph (B) of H. R. 6227 the Board is authorized on the application of any qualified bank holding corporation to extend such period from time to time with respect to such corporation for not more than 1 year at a time if, in its judgment, such an extension would not be detrimental to the public interest, but such period might not be extended beyond the date 5 years after the date of enactment of this part. This provision was modified by S. 2577, as originally reported, to provide that such period may not in any case be extended beyond the date 5 years after the date of enactment of this part or 5 years after the date on which the corporation becomes a bank holding company, whichever is later. The purpose of this change was to extend the specified periods in the case of corporations which become bank holding companies after the date of enactment of this part by reason of a distribution under section 1101. This treatment makes the specified periods uniform whether such a corporation chooses to distribute prohibited property or bank stock. In order that subsection (b) of section 1101 is to apply to distributions of property of a kind which causes a qualified bank holding corporation to be a bank holding company and the disposition of which is necessary to enable such corporation to cease being a bank holding company, it is essential that such corporation cease to be a bank holding company within the period (including extensions thereof) specified in subsection (e)(2) of section 1101. During the period during which such corporation disposes of property to enable it to cease being a bank holding company, distributions of such property are to be considered as being within subsection (b) of section 1101, if other requirements of this part are met. Thus, no gain would be recognized to shareholders on such distributions (if such distributions would otherwise qualify for the benefits of this part) during such period. If, at the close of such period specified in subsection (e)(2), the corporation has ceased to be a bank holding company, subsection (b) of section 1101 will apply to distributions of such property. However, if, at the close of such period, the corporation has not ceased being a bank holding company, then subsection (b) of section 1101 will not apply to any distributions of such property by the corporation. Thus, in a case where the provisions of subsection (e)(2) are not met, the tax treatment of any distributions of property of a kind which causes a qualified bank holding corporation to be a bank holding company to its shareholders is governed by the provisions of other sections of the Internal Revenue Code of 1954 applicable thereto.

Section 1102 provides special rules for the application of this part.

Subsection (a) relates to the basis of property acquired in distributions under either subsection (a) or subsection (b) of section 1101.

Paragraph (1) of subsection (a) relates to the basis of property received by a shareholder with respect to stock without the surrender by such shareholder of stock. If gain is not recognized by reason of section 1101(a) or (b) with respect to the receipt of any property then, under paragraph (1), the basis of such property and of the stock with respect to which it was distributed shall, in the hands of the distributee, be determined by allocating the adjusted basis of such stock between such property and such stock. Such allocation shall be made under regulations prescribed by the Secretary or his delegate.

Paragraph (2) of subsection (a) relates to the basis of property received by a shareholder in exchange for stock or by a security holder in exchange for securities. If gain is not recognized by reason of section 1101 (a) or (b) with

respect to the receipt of any property then, under regulations prescribed by the Secretary or his delegate, the basis of the property received shall, in the distributee's hands, be the same as the adjusted basis of the stock or securities exchanged, increased by (1) the amount of the property received which was treated as a dividend and (2) the amount of gain to the taxpayer recognized on the property received (not including any portion of such a gain which was treated as a dividend).

Subsection (b) of section 1102 of H. R. 6227 provided for the extension of the periods of limitation on the assessment and collection of deficiencies in tax arising from distributions to which subsection (a) or (b) of section 1101 applies. S. 2577, as originally reported, modified this provision of the House bill in several respects: (1) It eliminated the extension of the period under section 6502 relating to collections as unnecessary; (2) it provided that the extension applies to distributions certified by the Board under subsection (a) or (b) of section 1101 in order to correct a technical defect; (3) it provided that the notification by the corporation be in such manner and with such accompanying information as prescribed in regulations by the Secretary or his delegate; (4) it provided for a 5-year period after the notification instead of a 1-year period; and (5) it provided that the notification can only be made after the expiration of the period prescribed in section 4 (a) of the Bank Holding Company Act or section 1101(e), whichever is applicable, instead of after a final certification by the Board. The additional amendments proposed by your committee provide that the extension applies to all distributions certified by the Board under subsection (a), (b), or (c) of section 1101. Accordingly, under subsection (b) of section 1102, the periods of limitation provided in section 6501 (relating to limitations on assessment) shall not expire, with respect to any deficiency (including interest and additions to the tax) resulting solely from the receipt of property by shareholders in a distribution which is certified by the Board under subsection (a), (b), or (c) of section 1101, until 5 years after the distributing corporation notifies the Secretary or his delegate (in such manner and with such accompanying information as the Secretary or his delegate may by regulations prescribe) that the period (including extensions thereof) prescribed in section 4(a) of the Bank Holding Company Act, or section 1101(e)(2)(B), whichever is applicable, has expired. Such assessment may be made notwithstanding any provision of law or rule of law which would otherwise prevent such assessment.

Subsection (c) of section 1102 relates to allocation of earnings and profits. The amendments proposed by your Committee extend the rule relating to allocation of earnings and profits contained in section 1102(c) of S. 2577 as originally reported by your committee to the distribution of stock in a controlled corporation. Your committee believes it appropriate to provide a rule which is similar to that applied under section 312(i) in cases involving the distribution of stock of a controlled corporation under section 355. Accordingly, paragraph (1) of section 1101(c) provides that in the case of a distribution by a qualified bank holding corporation under section 1101(a)(1) or (b)(1) of stock in a controlled corporation, proper allocation with respect to the earnings and profits of the distributing corporation and the controlled corporation shall be made under regulations prescribed by the Secretary or his delegate. (Par. (3) of sec. 1101(c) defines the term "controlled corporation" in the same manner as sec. 368(c) of the Internal Revenue Code of 1954.) Paragraph (2) of section 1101(c) provides that in the case of any exchange described in section 1101(c)(2) or (3), the earnings and profits of the corporation transferring the property shall be properly allocated between such corporation and the corporation receiving such property under regulations prescribed by the Secretary or his delegate.

Subsection (d) relates to itemization of property distributed. The Board is required in any certification under this part to make such specification and itemization of property as may be necessary to carry out the provisions of this part.

Section 1103 sets forth the definitions, for purpose of this part, of "bank holding company," "qualified bank holding corporation," "prohibited property," "nonexempt property," and "Board."

Subsection (a) of this section provides that the term "bank holding company" means a bank holding company as defined by section 2 of the Bank Holding Company Act of 1956.

Subsection (b) of this section defines the term "qualified bank holding corporation." S. 2577, as originally reported, made a technical amendment to

subsection (b) in order to make it clear that the tax provisions of this part apply to any corporation as defined in section 7701(a)(3) of the Internal Revenue Code of 1954 if such corporation is a qualified bank holding corporation. In order for a corporation to be a qualified bank holding corporation, and therefore for its shareholders to receive the special tax treatment provided by this part, it must not only be a bank holding company but, in addition, it must hold "prohibited property" as defined in subsection (c). For example, if the sole assets of corporation X consist of 25 percent of the voting shares of each of two banks, corporation X is not a qualified bank holding corporation.

In addition, to be a qualified bank holding corporation the prohibited property must have been acquired on or before May 15, 1955, by a corporation which is a bank holding company, or must have been acquired in a distribution to it by a qualified bank holding corporation with respect to which gain is not recognized by reason of section 1101 (a) or (b). Furthermore, a bank holding company which holds prohibited property acquired by it in exchange for all of its stock in an exchange described in section 1101(c) (2) or (3) is a qualified bank holding corporation. (The amendments proposed by your committee add references to sec. 1101(b) and sec. 1101(c)(2) to par. (1) of sec. 1103(b) in order to conform the tax provisions of this bill to the change proposed by your committee in sec. 4(a)(2) of this bill.)

The preceding paragraph may be illustrated by the following examples:

(1) If the sole assets of corporation X on May 15, 1955, consist of cash and 25 percent of the voting shares of each of two banks and on May 30, 1955, corporation X purchases nonbanking business assets, corporation X is not a qualified bank holding corporation.

(2) The sole assets of corporation Y, on May 15, 1955, consist of 25 percent of the voting shares of each of two banks and 4 percent of the outstanding voting stocks (the value of which is less than 5 percent of the value of corporation Y's total assets) of corporation Z, a qualified bank holding corporation. Corporation Z distributes nonbanking business assets to corporation Y which are prohibited property in the hands of corporation Y, in a distribution to which section 1101(a) applies. Corporation Y becomes a qualified bank holding corporation by reason of the distribution by Z.

Notwithstanding that a corporation meets the requirements of paragraph (1) of subsection (b), such corporation shall not be a qualified bank holding corporation unless it meets the additional requirements of subparagraphs (A), (B), and (C) of paragraph (2).

Subparagraph (A) of paragraph (2) provides that a bank holding company shall not be a qualified bank holding corporation unless such corporation would have been a bank holding company on May 15, 1955, if the Bank Holding Company Act of 1956 had been in effect on such date, or unless such corporation is a bank holding company determined solely by reference to the following: (1) Property acquired by such corporation on or before May 15, 1955; (2) property acquired by such corporation in a distribution by a qualified bank holding corporation to such corporation wherein gain was not recognized by reason of subsection (a) or (b) of section 1101; and (3) property acquired by such corporation in exchange for all of its stock in an exchange meeting the requirements of section 1101(c)(2) or (3).

Thus, if on May 15, 1955, the sole assets of corporation X consist of cash and business assets and on May 30, 1955, corporation X acquires 25 percent of the voting shares of each of two banks for cash, then, by reason of subparagraph (A) of paragraph (2), corporation X, although a bank holding company holding prohibited property acquired by it before May 15, 1955, is not a qaulified bank holding corporation. Similarly, if corporation X acquired 25 percent or more more of the voting shares of each of two banks in a tax-free reorganization, corporation X, although a bank holding company holding prohibited property acquired by it before May 15, 1955, would not be a qualified bank holding corporation. An additional example of the application of subparagraph (A) of paragraph (2) is where corporation X is determined by the Board to be a bank holding company by reason of clause (2) of section 2(a) of the Bank Holding Corporation Act of 1956, solely by reference to (1) property acquired by such corporation on or before May 15, 1955, and (2) property acquired by it from a qualified bank holding corporation in a distribution in which gain to the distributee was not recognized by reason of subsection (a) or (b) of section 1101.

Except as explained in the next paragraph, subparagraph (B) of paragraph (2) provides that a bank holding company shall not be a qualified bank hold-

ing corporation by reason of either (1) the acquisition by such bank holding company of prohibited property after May 15, 1955, in a distribution from a qualified bank holding corporation to which section 1101(a) is applicable or (2) the acquisition by such bank holding company (which company would not have been a bank holding company on May 15, 1955, if the Bank Holding Company Act of 1956 had been in effect on such date) of property described in clause (ii) of subparagraph (A) of paragraph (2). An example of the operation of the foregoing is where, on May 15, 1955, the sole assets of corporation Y consist of cash and 25 percent of the voting shares of each of two banks. On May 30, 1955, corporation Y purchases for cash 50 percent of the stock of corporation Z, a qualified bank holding corporation. Corporation Z distributed business assets to corporation Y in a distribution in which gain to corporation Y with respect to the receipt of such property was not recognized by reason of section 1101(a). Corporation Y is not a qualified bank holding corporation since such property was acquired by corporation Y in a distribution with respect to stock acquired after May 15, 1955.

A bank holding company may be a qualified bank holding corporation by reason of the property described in the preceding paragraph if such property was acquired in a distribution with respect to stock which was acquired by such company (1) on or before May 15, 1955, (2) in a distribution (with respect to stock held by it on May 15, 1955, or with respect to stock in respect of which all previous applications of this clause are satisfied) with respect to which gain to it was not recognized by reason of subsection (a) or (b) of section 1101, or (3) in exchange for all of the stock of the bank holding company in an exchange meeting the requirements of section 1101(c)(2) or (3).

Subparagraph (C) of paragraph (2) states that a corporation may not be treated as a qualified bank holding corporation unless the Board certifies that it satisfies the requirements of subsection (b) of section 1103.

Subsection (c) of section 1103 defines the term "prohibited property." Such property is defined as property, other than nonexempt property, the disposition of which, in the case of any bank holding company, would be necessary or appropriate to effectuate section 4 of the Bank Holding Company Act of 1956, if such company continued to be a bank holding company beyond the period (including any extensions thereof) specified in section 4(a), in the case of distributions under section 1101(a), or specified in section 1101(e)(2)(B), in the case of distributions under section 1101(b). The term "prohibited property" does not include shares of any company which are held by a bank holding company to the extent that the ownership by such bank holding company of such property is not prohibited by section 4 of such bill by reason of subsection (c)(5) of such section.

Subsection (d) defines the term "nonexempt property," the distribution of which may not be accorded the tax treatment provided by this part.

Subsection (e) of this section states that the term "Board" means the Board of Governors of the Federal Reserve System.

Section 10(b) amends table of parts of chapter 1, subchapter O of Internal Revenue Code of 1954 by adding "Part VIII. Distributions pursuant to Bank Holding Company Act of 1955."

Section 10(c) makes these tax provisions in section 10(a) apply to taxable years ending after the enactment of the act.

[H. R. 2667—P. L. 414]

AMENDING SECTION 208(b) OF THE TECHNICAL CHANGES ACT OF 1953

[House of Representatives Report No. 1605, Eighty-fourth Congress, First Session]

[July 30, 1955]

Mr. Simpson of Pennsylvania, from the Committee on Ways and Means, submitted the following report [To accompany H. R. 2667]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 2667) to amend section 208 (b) of the Technical Changes Act of 1953 (Public Law 287,

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83d Cong.), having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE OF BILL

This bill amends section 208(b) of the Technical Changes Act of 1953 by making that provision applicable to estates of decedents dying after December 31, 1947, instead of to estates of decedents dying after December 31, 1950, as provided in the Technical Changes Act.

Section 208 of the Technical Changes Act of 1953 permitted for estate-tax purposes the tax-free release of certain powers over a discretionary trust described in section 1000(e) of the Internal Revenue Code of 1939, if the grantor was under a mental disability for a continuous period of not less than 3 months beginning before December 31, 1947, and ending with his death. The Technical Changes Act did not extend relief to a grantor under such a disability who died after December 31, 1947, and before January 1, 1951. This amendment would grant relief in such cases. The amendment is effective as if enacted as a part of section 208 (b) of the Technical Changes Act of 1953.

It is estimated that the revenue effect of this provision is negligible.

This bill has been reported unanimously by your committee.

[H. R. 2667—P. L. 414]

AMENDING SECTION 208(b) OF THE TECHNICAL CHANGES ACT OF 1953 AND FOR OTHER PURPOSES

[Senate Report No. 1401, Eighty-fourth Congress, Second Session. Calendar No. 1420]

[January 19 (legislative day, January 16), 1956]

Mr. Byrd, from the Committee on Finance, submitted the following report [To accompany H. R. 2667]:

The Committee on Finance, to whom was referred the bill (H. R. 2667) to amend section 208(b) of the Technical Changes Act of 1953 (Public Law 287, 83d Cong.), having considered the same, report favorably thereon with amendments and recommend that the bill, as amended, do pass.

The amendments are as follows:

At the end of the bill add the following:

SEC. 2. Section 2053 of the Internal Revenue Code of 1954 (relating to deductions from the gross estate for expenses, indebtedness, and taxes) is hereby amended by redesignating subsection (d) to be subsection (e) and by adding after subsection (c) a new subsection as follows:

"(d) CERTAIN STATE DEATH TAXES.—

"(1) GENERAL RULE.—Notwithstanding the provisions of subsection (c)(1)(B) of this section, for purposes of the tax imposed by section 2001 the value of the taxable estate may be determined, if the executor so elects before the expiration of the period of limitation for assessment provided in section 6501, by deducting from the value of the gross estate the amount (as determined in accordance with regulations prescribed by the Secretary or his delegate) of any estate, succession, legacy or inheritance tax imposed by a State or Territory or the District of Columbia, or any possession of the United States, upon a transfer by the decedent for public, charitable, or religious uses described in section 2055 or 2106(a)(2). The election shall be exercised in accordance with regulations prescribed by the Secretary or his delegate.

"(2) CONDITION FOR ALLOWANCE OF DEDUCTION.—No deduction shall be allowed under paragraph (1) for a State death tax specified therein unless the decrease in the tax imposed by section 2001 which results from the deduction provided for in paragraph (1) will inure solely for the benefit of the public, charitable, or religious transferees described in section 2055 or section 2106(a)(2). In any case where the tax imposed by section 2001 is equitably apportioned among all the transferees of property included in the gross estate, including those described in sections 2055 and 2106(a)(2) (taking into account any exemptions, credits, or deductions allowed by this chapter), in determining such decrease, there shall be disregarded any

decrease in the Federal estate tax which any transferees other than those described in sections 2055 and 2106(a)(2) are required to pay.

"(3) EFFECT OF DEDUCTION ON CREDIT FOR STATE DEATH TAXES.—See section 2011(e) for the effect of a deduction taken under this subsection on the credit for State death taxes."

SEC. 3. Section 2011 of the Internal Revenue Code of 1954 is amended by adding after subsection (d) a new subsection as follows:

"(e) LIMITATION IN CASES INVOLVING DEDUCTION UNDER SECTION 2053(d).—In any case where a deduction is allowed under section 2053(d) for an estate, succession, legacy, or inheritance tax imposed upon a transfer for public, charitable, or religious uses described in section 2055 or 2106(a)(2), the allowance of the credit under this section shall be subject to the following conditions and limitations:

"(1) The taxes described in subsection (a) shall not include any estate, succession, legacy, or inheritance tax for which a deduction is allowed under section 2053(d).

"(2) The credit shall not exceed the lesser of—

"(A) the amount stated in subsection (b) on a taxable estate determined by allowing the deduction authorized by section 2053(d), or

"(B) that proportion of the amount stated in subsection (b) on a taxable estate determined without regard to the deduction authorized by section 2053(d) as (i) the amount of the taxes described in subsection (a), as limited by the provisions of paragraph (1) of this subsection, bears to (ii) the amount of the taxes described in subsection (a) before applying the limitation contained in paragraph (1) of this subsection.

"(3) If the amount determined under subparagraph (B) of paragraph (2) is less than the amount determined under subparagraph (A) of that paragraph, then for purposes of subsection (d) such lesser amount shall be the maximum credit provided by subsection (b)."

SEC. 4. The amendments to the Internal Revenue Code of 1954 made by sections 2 and 3 of this Act, and provisions having the same effect as this amendment, which shall be considered to be included in chapter 3 of the Internal Revenue Code of 1939, shall apply to the estates of all decedents dying after December 31, 1953.

Amend the title so as to read:

An Act to amend section 208(b) of the Technical Changes Act of 1953, and for other purposes.

SECTION 1. AMENDMENT OF SECTION 208(b) OF THE TECHNICAL CHANGES ACT OF 1953

A. PURPOSE OF SECTION 1

Section 1 of this bill amends section 208(b) of the Technical Changes Act of 1953 by making that provision applicable to estates of decedents dying after December 31, 1947, instead of to estates of decedents dying after December 31, 1950, as provided in the Technical Changes Act.

B. GENERAL STATEMENT

Section 208 of the Technical Changes Act of 1953 permitted for estate-tax purposes the tax-free release of certain powers over a discretionary trust described in section 1000(e) of the Internal Revenue Code of 1939, if the grantor was under a mental disability for a continuous period of not less than 3 months beginning before December 31, 1947, and ending with his death. The Technical Changes Act did not extend relief to a grantor under such a disability who died after December 31, 1947, and before January 1, 1951. This amendment would grant relief in such cases. The amendment is effective as if enacted as a part of section 208(b) of the Technical Changes Act of 1953.

It is estimated that the revenue effect of this provision is negligible.

SECTIONS 2, 3, AND 4. AMENDMENT TO SECTIONS 2011 AND 2053 OF THE INTERNAL REVENUE CODE OF 1954

A. PURPOSE OF SECTIONS 2, 3, AND 4

Your committee has added another provision to this bill. Under present law, a deduction from the Federal estate tax is granted for bequests to charity.

Under the provision added by your committee, a deduction would also be granted (subject to certain conditions and limitations) for the amount of any estate succession, legacy, or inheritance tax imposed by a State upon the transfer by the decedent for public, charitable, or religious uses as described in section 2055 or, in the case of nonresident aliens, section 2106(a)(2).

Last year a similar provision was reported by your committee as an amendment to H. R. 6887. That bill, as amended, was passed but was not approved by the President. In the statement announcing that he had withheld his approval, the President stated that he was sympathetic with the objectives of he bill but that there were defects in the legislation that caused him to reluctantly withhold his approval from the bill. The provisions of sections 2, 3, and 4 are designed to accomplish the same purpose as the amendment added to H. R. 6887, and your committee has been advised by the Treasury Department that the provisions of this bill meet the objections raised in the President's statement.

In the determination of taxable estates for purposes of the Federal estate tax, deductions are granted by section 2055 (and 2106(a)(2) in cases of nonresident aliens) for bequests to charity. However, the amount of the deduction is measured by the amount the charity actually receives and not by the gross amount of the bequest. For example, if a State imposes a tax on the charitable bequest and the State tax must be paid from the charitable bequest, the estate tax charitable deduction would be limited to the amount of the bequest less the State tax paid from the bequest, and the Federal estate tax would be increased by the corresponding increase in the taxable estate of the decedent. If the additional Federal estate tax thus arising must also be paid out of the charitable bequest, the charitable deduction will, in turn, be reduced and the estate tax correspondingly increased. By this pyramiding of tax on tax, the Federal estate tax can be increased by much more than the State tax on the bequest, and the combination of these two taxes can result in the actual transfer to charity of an amount considerably less than the original bequest. Your committee's bill will prevent the pyramiding of the Federal estate tax in this manner by granting a deduction to the estate for the amount of the State death tax imposed upon a transfer for charitable purposes if the decrease in the Federal estate tax resulting from this deduction will inure solely to the benefit of a charitable transferee (but not necessarily the same charity that paid the State death tax).

B. Explanation of Sections 2 and 3

Section 2 of the bill adds a new subsection (d) to section 2053 of the Internal Revenue Code of 1954. Under subsection (d)(1), the value of the taxable estate may be determined by deducting from the value of the gross estate the amount of any State death taxes upon a transfer (or transfers) by the decedent for public, charitable, or religious uses described in section 2055 or, in the case of nonresident aliens, section 2106(a)(2).

Since the deduction which would be authorized by section 2053(d) might increase the tax payable by some estates, it is provided that the decedent's personal representative must make an election to claim the deduction. The election may be made at any time prior to the time any further assessment of tax against the estate is barred by section 6501 (statute of limitations). The election would be made in accordance with regulations to be prescribed by the Secretary or his delegate. No deduction would be allowed for a State death tax imposed on a bequest to noncharitable beneficiaries.

In order to eliminate any confusion as to the amount of a State estate tax (as distinguished from inheritance, legacy, and succession taxes) which is in effect imposed upon transfers to charity, a provision in subsection (d)(1) authorizes the Secretary or his delegate to prescribe by regulations the method to be followed in allocating the portion of the State estate tax to the charitable transfers.

Under subsection (d)(2), the benefit of the deduction will inure solely to charity where the entire Federal estate tax is payable out of bequests to charity and also in cases where the State death tax is paid by charity and the Federal estate tax is equitably apportioned among all of the beneficiaries (including charity) of property included in the gross estate. The Federal estate tax is equitably apportioned among all the beneficiaries where each beneficiary is required to pay the portion of the tax which is attributable to his bequest, after taking into account any deduction or credit allowed (by the estate tax chapter of the code) with respect to that bequest in the determination of the estate tax payable. The amendment to section 2053(d) would eliminate this

pyramiding of the Federal estate tax at the expense of charity in these two types of cases.

For example, assume that the testator bequeaths $100,000 to A, $100,000 to B, and $100,000 to C, a charity, and directs that each legatee bears his proportionate share of the Federal estate tax based on the net amount of his bequest includible in the taxable estate. Assume also that State X imposes a 15-percent inheritance tax on charitable bequests. On the basis of these facts, the estate would be entitled to a deduction under this section of $15,000 and a charitable deduction of $85,000. Under the provisions of the will, the charity would pay no Federal estate tax because deductions totaling $100,000 allowed in connection with the charitable bequest have the effect of reducing the amount of the charitable bequest includible in the taxable estate to zero. A and B would each, therefore, be required to pay one-half of the Federal estate taxes. In the absence of the deduction of $15,000 allowed under this section, the charity would have been required to bear the Federal estate tax attributable to the inclusion of such amount in the taxable estate. If, on the other hand, the testator directed that A, B, and C each bear one-third of the Federal estate tax, the deductions provided for in this bill would not be allowed. In such case, the charitable deduction is not taken into account and the charity would be required to bear Federal estate tax imposed on the bequests to A and B. Thus, the requirement of the bill that the benefit inure solely to charity would not be satisfied.

Where charity pays the entire Federal estate tax, it naturally would receive all of the benefit of the deduction allowed by subsection (d)(1). It will also receive the benefit of the deduction where charity must pay the portion of the Federal estate tax attributable to the State death tax borne by it since the primary result of the deduction is the elimination of this portion of the Federal estate tax.

In the apportionment cases referred to, the noncharitable beneficiaries receive an incidental benefit by reason of the fact that the average rate of tax imposed on the taxable estate determined by allowing the deduction is lower than the average rate of tax imposed on the taxable estate determined without allowance of the deduction. This incidental benefit resulting from the lowering of the average tax rate would be disregarded in determining whether charity receives the entire benefit of the deduction.

Section 3 of this bill amends section 2011 of the 1954 code, relating to credit for State death taxes. The allowance of this deduction under section 2053(d) makes certain changes necessary in section 2011 in order that (1) the estate does not receive a credit as well as a deduction for the same payment to a State, (2) the bequest that bears the Federal estate tax attributable to the State death tax on noncharitable transfers will receive the same benefit as under present law, and (3) the change in the method of determining the Federal estate tax will not change the application of State pickup tax laws.

Section 2011(e) (a new subsection added by section 3 of this bill) provides the general rule in paragraph (1) that no credit shall be allowed for any State death tax for which a deduction has been allowed.

Section 2011(e)(2) provides that the maximum amount allowable as a credit for State death taxes shall not exceed the amount of the credit computed without regard to section 2053(d) which is attributable to the State death tax on the transfers other than those described in sections 2055 or 2106(a)(2). This paragraph also provides that the credit for State death taxes shall not exceed the maximum amount that would be allowable for a taxable estate determined by allowing the deduction provided for in section 2053(d).

Under paragraph (3) of section 2011(e), the basic estate tax will be determined by reference to the maximum credit allowable under paragraph (2)(B) when the maximum credit allowable is the amount provided under that provision. In a case where the deduction under section 2053(d) is allowed, the basic estate tax, which forms the basis for the application of State pickup tax laws, would be 125 percent of the maximum credit allowable as described in paragraph (2).

C. Explanation of Section 4

Under section 4 of this bill, the deduction allowed by section 2, together with the provisions in section 3, are considered to be included in the estate tax imposed by the Internal Revenue Code of 1939. Therefore, in the case of decedents dying after December 31, 1953, a deduction may be allowed (at the election of the executor) for the State tax imposed on bequests to charity under the same conditions and limitations that would be available in the case of a decedent dying after the enactment of the 1954 code.

[H. R. 4582—P. L. 396]

CARRYOVER OF UNUSED PENSION TRUST DEDUCTIONS IN CERTAIN CASES

[House of Representatives Report No. 1594, Eighty-fourth Congress, First Session]

[July 29, 1955]

Mr. SIMPSON of Pennsylvania, from the Committee on Ways and Means, submitted the following report [to accompany H. R. 4582]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 4582) to amend the Internal Revenue Code of 1954 with respect to deductions from gross income of amounts contributed to employees trusts, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 2, line 4, after "transfer" insert:

(but not for taxable years with respect to which this paragraph does not apply).

Page 2, line 14, after "Internal" insert "Revenue".

Page 2, after line 14, insert:

SEC. 2. The amendments made by the first section of this Act shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

PURPOSE OF BILL

The purpose of H. R. 4582 is to permit, under certain circumstances, a corporation which has acquired the properties and assumed the liabilities of a wholly owned subsidiary in a tax-free liquidation under section 112(b)(6) of the 1939 Code, to utilize any excess contributions made by the subsidiary to a qualified pension plan as though it were the subsidiary corporation for this purpose. These excess contributions are to be available as deductions in years beginning after December 31, 1953, and ending after August 16, 1954.

GENERAL STATEMENT

Under the 1939 Code whether tax benefits and elective rights were available to a successor corporation when the assets of two or more predecessor corporations were combined in a tax-free reorganization or liquidation depended upon the legal form in which the combination was effectuated.

The 1954 Code prescribes a series of definite rules under which specified tax benefits, elective rights, and obligations will carry over to successor corporations in certain tax-free liquidations and reorganizations. Included in this list of items is the right to treat the successor corporation as though it were the predecessor corporation for purposes of determining amounts deductible for contributions of an employer corporation to an employees' pension, profit-sharing and stock bonus trust or annuity plan. This provision in the 1954 Code applies, however, only to qualifying tax-free liquidations and reorganizations, the tax treatment of which is determined under the 1954 Code.

Cases have been called to the attention of the committee in which a tax-free merger of a subsidiary corporation under the 1939 Code was prevented because the corporate laws of the State of incorporation of the subsidiary required that the surviving corporation be incorporated in that State. In these instances the parent corporation (which was incorporated in a different State than the subsidiary) liquidated the subsidiary and acquired its properties in a tax-free liquidation under section 112(b)(6) of the 1939 Code. It was therefore not entitled to utilize the unused excess contributions made by the subsidiary corporation to the employees' pension plan of the subsidiary even though these excess contributions would have been allowable as a carryover to the subsidiary if its corporate existence had not been terminated. Since the successor corporation would have been entitled to the carryover of the unused pension trust contributions of the subsidiary if the tax consequences of liquidation of the subsidiary had been determined under the applicable provisions of the 1954 Code, your committee believes that the successor corporation should not be denied this carryover because the liquidation came under the 1939 Code.

The bill thus makes the carryover available to the successor corporation in such cases if (1) the corporate laws of the State of incorporation of the subsidiary required the surviving corporation in the case of a merger to be incorporated under the laws of the State of incorporation of the subsidiary and (2) the properties were acquired in a tax-free liquidation of the subsidiary under section 112(b)(6) of the 1939 Code.

Under the bill the successor corporation will therefore be entitled to utilize any unused excess pension contributions of the predecessor in any taxable year beginning after December 31, 1953, and ending after August 16, 1954.

[H. R. 4582—P. L. 396]

AMENDING THE INTERNAL REVENUE CODE OF 1954 WITH RESPECT TO DEDUCTIONS FROM GROSS INCOME OF AMOUNTS CONTRIBUTED TO EMPLOYEES TRUSTS

[Senate Report No. 1375, Eighty-fourth Congress, Second Session. Calendar No. 1395]

[January 12, 1956]

Mr. Byrd, from the Committee on Finance, submitted the following report [to accompany H. R. 4582]:

The Committee on Finance, to whom was referred the bill (H. R. 4582) to amend the Internal Revenue Code of 1954 with respect to deductions from gross income of amounts contributed to employees trusts, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

By virtue of this action, the Committee on Finance accepts the report of the Committee on Ways and Means, which is as follows:

[See House Report No. 1594, page 924 this Bulletin]

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[H. R. 5428—P. L. 397]

AMENDING THE INTERNAL REVENUE CODE OF 1939 WITH RESPECT TO THE PERIOD OF LIMITATION FOR FILING CLAIMS BY CERTAIN TRANSFEREES AND FIDUCIARIES FOR CREDIT OR REFUND OF INCOME TAXES

[House of Representatives Report No. 1448, Eighty-fourth Congress, First Session]

[July 27, 1955]

Mr. Keogh, from the Committee on Ways and Means, submitted the following report [to accompany H. R. 5428]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 5428) to amend the Internal Revenue Code of 1954 to provide that chapter 71 relative to transferees and fiduciaries shall apply with respect to any tax imposed by the Internal Revenue Code of 1939, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Strike out all after the enacting clause and insert:

That section 311 (b) (4) of the Internal Revenue Code of 1939 is hereby amended by inserting "(A)" after "(4)" and by adding at the end thereof the following:

"(B) For the purpose of determining the period of limitation on credit or refund to the transferee or fiduciary of—

"(i) overpayments of tax made by such transferee or fiduciary, or

"(ii) overpayments of tax made by the transferor of which the transferee or fiduciary is legally entitled to credit or refund,

the agreement referred to in subparagraph (A) and any extension thereof shall be deemed an agreement and extension thereof referred to in section 322 (b) (3).

"(C) If the agreement referred to in subparagraph (A) is executed after the expiration of the period of limitation for assessment against the taxpayer with reference to whom the liability of such transferee or fiduciary arises, then, in applying the limitations under section 322 (b) (3) on the amount of the credit or refund, the periods specified in section 322 (b) (3) shall be increased by the period from the date of such expiration to the date of the agreement."

SEC. 2. This Act shall be effective in all circumstances in which it would have been effective if it had been enacted on August 17, 1954.

Amend the title so as to read:

A bill to amend the Internal Revenue Code of 1939 with respect to the period of limitation for filing claims by certain transferees and fiduciaries for credit or refund of income taxes.

PURPOSE OF BILL

The bill as reported amends the Internal Revenue Code of 1939 to provide that an agreement extending the period within which the liability of a transferee or fiduciary with respect to income taxes may be asessed also extends the period with respect to credit or refund of such liability. This amendment is to be effective in all circumstances in which it would be effective if it had been enacted on August 17, 1954, with respect to income taxes imposed under the 1939 code.

REASONS FOR BILL

Under section 311 of the 1939 code, the period of limitations for assessment of an income-tax liability of a transferee or fiduciary could be extended by an agreement between such transferee or fiduciary and the Commissioner of Internal Revenue. However, this agreement did not extend parity of treatment by granting an extension of the time for the filing of a claim for credit or refund of income tax by the transferee or fiduciary in most cases. This inequity was remedied in the 1954 code with respect to the liability of a transferee or fiduciary but only in the case of taxes imposed by that code. The bill would grant similar treatment to a transferee or fiduciary with respect to income taxes imposed by the 1939 code, as if it had been enacted on August 17, 1954.

EXPLANATION OF BILL

The bill as reported provides that an agreement (and any extension of the agreement) between the Commissioner of Internal Revenue and a transferee or fiduciary extending the period for assessment of income-tax liability of the transferee or fiduciary is to be considered as an agreement and an extension of time for filing a claim for (or allowing or making) a credit or refund in the manner and to the extent, provided for taxpayers in general by section 322 (b) (3) of the 1939 code. The agreement is made applicable to the periods prescribed in section 322 (b) (3) for the filing of a claim for credit or refund (or for the allowance of credit or making refund where no claim is filed) with respect to overpayments made by the transferee or fiduciary and also with respect to overpayments made by a transferor to which the transferee or fiduciary is legally entitled.

In the case of such an agreement, section 322 (b) (3) limits the amount of any credit or refund to the amount of tax paid within a period of time specified in the section. Where the agreement is made after the period of time for assessment against the taxpayer has expired, the periods prescribed under section 322 (b) (3), relating to the limitation on the amount of credit or refund which may be made, are also increased by the period of time which elapsed between the date of expiration of the period for assessment against the taxpayer and the date of the agreement.

This is the same treatment as is provided under the 1954 code.

As amended by your committee, the period for credit or refund is extended only as to the liability of a transferee or fiduciary with respect to income taxes.

Your committee is unanimous in reporting this bill as amended.

[H. R. 5428—P. L. 397]

AMENDING THE INTERNAL REVENUE CODE OF 1939 WITH RESPECT TO THE PERIOD OF LIMITATION FOR FILING CLAIMS BY CERTAIN TRANSFEREES AND FIDUCIARIES FOR CREDIT OR REFUND OF INCOME TAXES

[Senate Report No. 1376, Eighty-fourth Congress, Second Session. Calendar No. 1396]

[January 12, 1956]

Mr. Byrd, from the Committee on Finance, submitted the following report [to accompany H. R. 5428]:

The Committee on Finance, to whom was referred the bill (H. R. 5428) to amend the Internal Revenue Code of 1954 to provide that chapter 71 relative to transferees and fiduciaries shall apply with respect to any tax imposed by the Internal Revenue Code of 1939, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

By virtue of this action, the Committee on Finance accepts the report of the Committee on Ways and Means, which is as follows:

[See House Report No. 1448, page 925 this Bulletin]

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[H. R. 6227—P. L. 511]

BANK HOLDING COMPANY ACT OF 1955

[House of Representatives Report No. 609, Eighty-fourth Congress, First Session] [3]

[May 20, 1955]

Mr. Spence, from the Committee on Banking and Currency, submitted the following report [To accompany H. R. 6227]:

The Committee on Banking and Currency, to whom was referred the bill (H. R. 6227) to provide for the control and regulation of bank holding companies, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

* * * * * * *

MAJOR PROVISIONS OF H. R. 6227

Your committee is convinced from the evidence presented during its recent hearings that this bill represents the minimum legislation necessary to deal with the bank holding company problem. The committee wishes to make clear that the legislation which it proposes is not designed to abolish bank holding companies or to prohibit the expansion, within certain limits, of existing bank holding companies. The bill would impose controls which the committee deems desirable over the creation and expansion of bank holding companies and would require them to separate their business of managing and controlling banks from unrelated businesses. The bill contains five major provisions.

First, the bill would set forth a declaration that it is the policy of the Congress (*a*) to control the creation and expansion of bank holding companies, (*b*) to separate their business of managing and controlling banks from unrelated business, (*c*) generally to maintain competition among banks and to minimize the danger inherent in concentration of economic power through centralized control of banks, and (*d*) to subject bank holding companies to examination and regulation. It is the opinion of your committee that bank holding companies should be subject, insofar as practicable, to the same type of examination as the banks which they control.

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[3] This publication of the Committee Report is restricted to excerpts involving internal revenue matters.

Second, the bill would define a bank holding company as any company which either (*a*) controls 25 percent or more of the voting shares of 2 or more banks or of a bank holding company, or (*b*) is found by the Board of Governors of the Federal Reserve System, after notice and opportunity for hearing, to exercise a controlling influence over 2 or more banks. Certain exemptions from the definition of "bank holding company" are, however, provided. These are as follows: (*a*) Any corporation a majority of the shares of which are owned by the United States or any State, (*b*) banks which own or control shares solely in a fiduciary capacity (except where such shares are held for the benefit of all or a majority of the persons beneficially interested in such bank), and (*c*) any mutual savings bank, and any nonprofit organization operating exclusively for charitable, religious, and similar purposes which would otherwise be a bank holding company by reason of its ownership of bank stock on the effective date of the act.

Third, the bill would require bank holding companies to obtain the prior approval of the Board of the Federal Reserve System before acquiring additional bank stocks or assets. The Board, before granting approval of any application, would be required to ask for the recommendation of the agency that chartered the bank or banks involved, the Comptroller of the Currency in the case of a National bank and the State supervisor in the case of a State bank. If such an agency denied approval within 30 days that action would be final, but if approval was granted then the Board, of course, in the light of the overall situation still could make its own determination.

Fourth, the bill would require bank holding companies within a maximum of 5 years to divest themselves of interests in nonbanking enterprises. Suitable tax relief on the distribution of such interests made at the order of the Board, or where because of such an order a company chooses to distribute its holdings of bank shares so as to cease to be a bank holding company, is provided.

Fifth, the bill would prohibit a bank subsidiary of a bank holding company from investing any of its funds in, or lending any of its funds on the security of the stock or other securities of the holding company of which it is a subsidiary, and other subsidiaries thereof, and would prohibit the bank from making loans to its bank holding company and other subsidiaries.

DEFINITION OF A BANK HOLDING COMPANY

The bill defines a bank holding company as any company which either (*a*) controls 25 percent or more of the voting shares of 2 or more banks or of a bank holding company, or (*b*) is found by the Board of Governors of the Federal Reserve System, after notice and opportunity for hearing, to exercise a controlling influence over 2 or more banks. Certain exemptions from the definition of "bank holding company" are, however, provided. These are as follows: (*a*) Any corporation a majority of the shares of which are owned by the United States or any State, (*b*) banks which own or control shares solely in a fiduciary capacity (except where such shares are held for the benefit of all or a majority of the persons beneficially interested in such bank), and (*c*) any mutual savings bank, or any organization operating exclusively for charitable, religious, and similar purposes which would otherwise be a bank holding company by reason of its ownership of bank stock on the effective date of the act.

Your committee is unable to endorse the definition of "bank holding company" proposed by the Federal Reserve Board. It recommended that a "bank holding company" be defined as any company which owns or controls, directly or indirectly, a majority of the shares of one or more banks. Such a definition would perpetuate the long-recognized deficiencies of the definition of the term "holding company affiliate" contained in present law. This definition is based primarily on ownership or control of a majority of the shares of a bank or of the shares voted in the last election of directors of a bank. Congress and the courts have recognized the fact that control is often exercised through ownership of much less than a majority of the shares of a corporation. In the Public Utilities Holding Company Act of 1930, for example, the Congress defines a holding company as follows:

> * * * any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public-utility company or of a company which is a holding company by virtue of this clause or clause (B), unless the Commission, as hereinafter provided, by order declares such company not to be a holding company.

In the Investment Companies and Advisers Act, "control" is defined in this manner:

> Control means the power to exercise a controlling influence over the management of policies of a company, unless such power is solely the result of an official position with such company.
>
> Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company.

Ownership of a majority of the shares voted in the preceding election of directors is equally unrealistic. In marked contrast to its present position the Board in its 1943 annual report acknowledged it when 't stated:

> In the Board's experience, the case in which regulation is most necessary is likely also to be the case in which advantage has been taken of the gaps in the statutory definition with respect to the number of shares owned or controlled. The Board believes that these gaps should be filled in by incorporating in the statute a more realistic definition envisaging the manner and means by which effective control actually is exercised.

The type of definition now proposed by the Federal Reserve Board would not cover some existing groups which are in effect bank holding companies. More important, it is quite possible it would not cover arrangements for control of a number of banking units which could easily be devised in the future to escape coverage of the definition proposed by the Board. In contrast, your committee believes the definition of "bank holding company" contained in H. R. 6227 is a realistic definition fully adequate to meet these possibilities of evasion.

As pointed out previously this bill does not deal with banks owned by an individual. The definition of "company" contained in the bill does not include an individual, and it also specifically excludes the administrator of a person's estate, the executor of a person's will, and the trustees of a testamentary trust. Also excluded would be an irrevocable trust the corpus of which is donated by one person and consists only of such person's property. In connection with the latter exclusion, however, your committee desires to point out that the exclusion is only intended to cover bona fide trusts created for specifically named beneficiaries. The exclusion is not to be used to evade the purposes of the act. For instance, if a number of individuals owning stock in the same banks create such trusts for the purpose of controlling the banks through the voting of the trustees in concert, such trusts would not be bona fide trusts entitled to exclusion from the provisions of this bill. Your committee desires to alert the Federal Reserve Board in this respect, and requests the Board to inform your committee and the Congress in its annual reports of attempts to use this particular exclusion for the purpose of evading the purposes of the bill.

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TAX RELIEF FOR DISTRIBUTIONS MADE UNDER THE ACT

The bill would add a new part VIII to subchapter O of the Internal Revenue Code of 1954. Under this new part, tax relief is accorded to distributions which are made pursuant to the Bank Holding Company Act of 1955 within the period prescribed in the act.

In general, a corporation which comes within the terms of the act as a bank holding company is given its choice of two alternative routes (that is, to remain a bank holding company, or to dispose of its interests in banks).

If the corporation decides to remain a bank holding company subject to the supervision of the Federal Reserve Board, it may distribute any "prohibited property," which the Board certifies is necessary or appropriate to comply with the act, to its shareholders without the recognition of gain by the shareholders on the distribution. For this purpose "prohibited property," in general, means stock, securities and other obligations, or other assets of nonbanking businesses to the extent the bank holding company is required to divest itself of such assets under section 6(a) of the bill. The term, however, does not include cash, Government bonds, or certain short-term obligations. In the ordinary case cash and cash equivalents, such as Government bonds and short-term obligations, will not come within section 6(a) of the bill as property which must be disposed of by the bank holding company. It is believed desirable, however, to expressly exclude cash, etc., from the definition of "prohibited property," since a similar exclusion

is contained in the comparable provisions of part VI of subchapter O, relating to exchanges in obedience to SEC orders.

With respect to the distributing corporation, the usual provisions of the Internal Revenue Code of 1954 apply. Under these provisions, gain generally is not recognized to the distributing corporation except under unusual circumstances such as the distribution of LIFO inventory, the distribution of property subject to a liability in excess of the adjusted basis, or the distribution of certain installment obligations.

The distribution of "prohibited property" may be made either directly to the shareholders of the corporation which is a bank holding company or may be transferred to a wholly owned subsidiary expressly created for purposes of receiving the prohibited property. The stock of the subsidiary must be immediately distributed to the shareholders of the corporation which is a bank holding company if the distribution is to be made under this bill without the recognition of gain to the shareholders.

If a corporation which qualifies as a bank holding company under the act chooses the second alternative route, it may distribute to its shareholders any bank stock or other property of a kind which causes it to be a bank holding company, without the recognition of gain to the recipient stockholders. The Board must certify, however, that distribution of property of that kind is necessary or appropriate to effectuate the policies of the act. In such a case, the corporation may, for example, distribute to its shareholders all of its shares of bank stock without the recognition of gain even though it would be possible to retain shares of stock in one bank without being classified as a bank holding company. Your committee believes that this treatment is necessary because a corporation which is compelled to divest itself of part of its bank stock by reason of the act may wish to distribute all of its shares of bank stock, so that no possibility will exist that it will be classified as a bank holding company in the future.

Your committee contemplates that the Federal Reserve Board in the discharge of its functions in making certifications that exchanges and distributions are necessary or appropriate to effectuate the purposes of the act will carefully scrutinize the facts and circumstances in each case to prevent abuses and will cooperate fully with the Treasury Department to this end. Although the time of recognition of gain may be legitimately shifted under the provisions of this part, nothing in these provisions is to be construed or applied in such manner as to permit tax evasion or sham transactions entered into for avoiding tax.

Your committee has restricted the nonrecognition treatment described above to property which was owned on May 15, 1955. This restriction is deemed necessary to prevent corporations from purchasing interests in banks or other property in order that their shareholders may get the benefit of the tax treatment provided in the act. The restriction would not apply, however, if the property was received in a transaction in which gain was not recognized because of the general rules described above. For example, if prohibited property was distributed by a subsidiary to its parent in a corporate chain without recognition of gain to the parent by reason of these provisions, the parent, in turn, may distribute the property to its own shareholders without recognition of gain under a certification by the Board, even though the property was acquired by the parent after May 15, 1955. Similarly, the May 15, 1955, cutoff date is not applicable where the prohibited property or bank stock (or other similar property) certified by the Board is transferred to a wholly owned subsidiary created for that purpose and the stock of the subsidiary is immediately distributed by the qualified bank holding corporation to its shareholders.

As in the case of the first alternative route, nonrecognition treatment is available whether the bank stock or other similar property certified by the Board is distributed directly to shareholders or whether it is first transferred to a wholly owned subsidiary expressly created for that purpose and the stock of the subsidiary is then immediately distributed to the shareholders of the parent.

To prevent certain tax avoidance possibilities that might otherwise exist, your committee's bill does not extend nonrecognition treatment, under the general rules described above, to any portion of a distribution attributable to a contribution to the capital of any corporation where the contribution is made after May 15, 1955. This restriction applies whether or not the contribution to capital is made by a shareholder of the corporation receiving such contribution. In the case of a contribution to the capital of a bank, however, the limitation does not apply if it is determined that avoidance of Federal income tax was not a principal purpose of the contribution.

Where the nonrecognition treatment has been extended to "prohibited property" which has been distributed by the corporation which is a bank holding company, a final certification must be obtained from the Board that the corporation has divested itself of all property necessary for compliance with the act within the statutory period permitted for divestment. If this final certification is not obtained, the transactions previously permitted to be made without recognition of gain are reopened and tax may be imposed in such cases. For this purpose the statute of limitations on assessment of a deficiency resulting solely from such a transaction does not expire until 1 year after the date on which the corporation gives notification that a final certification by the Board has been made.

A similar final certification is required where nonrecognition treatment has been originally accorded to the distribution of bank stock or similar property of a kind which the Board has certified as necessary so that the corporation will cease to be a bank holding company. In this case the tax provisions of the bill provide that the Board must give a final certification that the corporation has ceased to be a bank holding company within 2 years after the date of enactment unless the time has been extended by the Board for 1-year renewals not to exceed 5 years from date of enactment.

MISCELLANEOUS PROVISIONS

The bill contains a number of miscellaneous provisions, some of which are of substantive importance, and some of which are technical in nature.

The basis of stock or other property received by a distributee without recognition of gain under the provisions of the bill is determined by allocating the adjusted basis of the stock with respect to which the distribution was made between such stock and the property so distributed. This rule is similar to the general rule for allocation of basis in the case of a stock dividend. The bill provides that the allocation shall be made under regulations provided by the Secretary or his delegate.

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SECTION-BY-SECTION ANALYSIS OF THE BILL

Section 1.—This section provides that this act may be cited as the Bank Holding Company Act of 1955.

Section 2.—This section sets forth a declaration of policy by the Congress that the creation and expansion of bank holding companies be subjected to control, that bank holding companies be required to separate their business of managing and controlling banks from unrelated businesses and that bank holding companies be subjected to the same type of examination and regulation as the banks which they control. The section further provides that it is a policy of the Congress generally to maintain competition among banks and to minimize the danger inherent in the concentration of economic power through centralized control of banks.

Section 3.—Subsection (a) defines the term "bank holding company" to mean any company which directly or indirectly owns or controls 25 percent or more of the voting shares of 2 or more banks or of a company which is or becomes a bank holding company by virtue of this act; or any company which, after notice and hearing, is determined by the Board of Governors of the Federal Reserve System to exercise directly or indirectly a controlling influence over the management or policies of 2 or more banks. A successor to any such bank holding company for purpose of the act is deemed to be a bank holding company as of the date of predecessor company became a bank holding company. However, no (1) mutual savings bank, (2) nonprofit religious, charitable, scientific, or educational organization, nor (3) company owning banks with aggregate deposits of less than $15 million as of December 31, 1954, shall be classed as or held to be a bank holding company by reason of the ownership of the stock of any bank as of the effective date of the act. A provision of the definition specifically excludes any corporation wholly owned by the United States, or any bank owning or controlling shares in a fiduciary capacity except where such shares are beneficially held for all or a majority of the persons interested in the bank.

Subsection (b) defines a "subsidiary" of a specified bank holding company in terms of the ownership and control tests applicable to a bank holding company.

Subsection (c) defines the term "company" to include any bank, corporation, partnership, joint-stock company, business trust, voting trust, association, or any similar organized group of persons whether incorporated or not. However, any

such company the majority of the shares of which are owned by the Federal Government or by any State are excluded.

Subsection (d) defines the term "bank" to include any national or State bank, savings bank or trust company, but excludes any organization which does not do business within the United States. The subsection also defines the terms "State member bank" and "district bank."

Subsection (e) defines the term "successor" and gives the Board of Governors of the Federal Reserve System the right by regulation to further define the term "successor" to the extent necessary to prevent evasion of the purposes of the act.

Subsection (f) makes clear that where the term "Board" is used in the act the reference is to the Board of Governors of the Federal Reserve System.

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Section 11.—This section contains technical amendments to banking acts and other acts to reflect the provisions of this act.

Subsection (a) amends the 16th paragraph of section 4 of the Federal Reserve Act which pertains to the nomination and election of class A and class B directors of Federal Reserve banks.

Subsection (b) provides for repeal of the last sentence of paragraph 19 and all of paragraph 22 of section 9 of the Federal Reserve Act. These paragraphs respectively deal with the penalty imposed on a State member bank for failure to obtain reports of holding company affiliates and the applicability of voting permit conditions to State member banks affiliated with a holding company affiliate.

Subsection (c) provides for repeal of subsection (c) of section (2) of the Banking Act of 1933, as amended. That subsection contains the definition of a "holding company affiliate" under that act.

Subsection (d) rewrites section 5144 of the Revised Statutes, as amended, so as to delete the provisions of that section relating to voting permits of holding company affiliates of national banks.

Subsection (e) amends section 5211 of the Revised Statutes so as to remove a sentence subjecting holding company affiliates to the reporting provisions of that section.

Subsection (f) amends subchapter O of chapter 1 of the Internal Revenue Code of 1954 by adding a new part VIII. This part VIII specifies the extent to which (during a transition period after the enactment of the bill) gain will not be recognized upon receipt of property by a shareholder of a bank holding company, if such distribution is made pursuant to a certification by the Board of Governors of the Federal Reserve System that such distribution is necessary or appropriate to effectuate the Bank Holding Company Act of 1955. The provisions of the new part VIII are restricted by their own terms to the gain directly attributable to the receipt of property in the distributions specifically described.

The rules contained in part VIII are in addition to the other provisions of subtitle A of the Internal Revenue Code of 1954 (such as provisions relating to the recognition or nonrecognition of gain to a corporation making distributions, the provisions under which tax-free reorganizations may be effectuated, etc.). Many of these other provisions are contained in subchapter C of chapter 1 of such code (relating to corporate distributions and reorganizations). The provisions of part VIII supersede the other provisions of chapter 1 only in the cases qualifying under part VIII, and in those cases only to the extent specific provision is contained in part VIII.

Section 1101 sets forth the conditions for nonrecognition of gain attributable to distributions of property by a qualified bank holding corporation when received by the shareholder with respect to his stock in such corporation. In addition rules are provided as to the date the qualified bank holding corporation must have acquired the property before it can be distributed with no gain recognized to its shareholders as a result of the distribution. This section also prescribes certain conditions which must be fulfilled before any such distributions of property will obtain the nonrecognition of gain benefits of its provisions.

Subsection (a) of section 1101 provides that a distribution of prohibited property by a qualified bank holding corporation with respect to its stock and without the surrender by the shareholder of any stock or securities in such corporation will not result in any gain being recognized on the receipt of such property by the shareholder if the Board has, before the distribution, certified that the distribution of such property is necessary or appropriate to carry out the first

sentence of section 6(a) of the Bank Holding Company Act of 1955. On the date of distribution the distributing corporation must have been a qualified bank holding corporation. The first sentence of section 6(a) provides in general that it shall be unlawful for any bank holding company, after 2 years from the effective date of the Bank Holding Company Act of 1955, to own any shares or other securities or obligations of any company other than a bank or to engage in any business other than that of banking, or of managing or controlling banks, or of the kind of businesses enumerated in section 6(c)(1) of the act. However, such section 6(c) sets forth certain exceptions and permits the holding by a bank holding company of certain types of property.

Subsection (b) of section 1101 applies to a distribution of property by a qualified bank holding corporation, with respect to its stock, to a shareholder without the surrender by the shareholder of stock or securities in such corporation where the Board has before the distribution certified that (1) such property is of a kind which causes such corporation to be a bank holding company, (2) the disposition of property of that kind is necessary to enable such corporation to cease being a bank holding company, and (3) the distribution is necessary or appropriate to effectuate the policies of the Bank Holding Company Act of 1955. In the case of a distribution falling within subsection (b), no gain to the shareholder upon the receipt of such property is to be recognized. Property which is intended to be covered by subsection (b) of section 1101 is that property or properties which is of a kind which causes a company to be a bank holding company within the provisions of section 3(a) of the Bank Holding Company Act of 1955. Thus, assuming that all the conditions of this part are met, a qualified bank holding corporation may distribute to its shareholders without the recognition of gain to them upon such distribution, part or all of the voting shares of one or more of the banks the ownership of which voting shares was the basis upon which such corporation is a bank holding company, if the Board makes the certification required by paragraph (2) of subsection (b). Furthermore, if any corporation was held by the Board to be a bank holding company under clause 2 of section 3(a) of the Bank Holding Company Act, and if such corporation is a qualified bank holding corporation as required by this part, such corporation would be permitted to distribute whatever property it owned upon the basis of which such determination was made by the Board to its shareholders without recognition of the gain on the distribution, if the Board certifies in accord with paragraph (2).

A qualified bank holding corporation which distributes prohibited property with respect to which the Board has certified as required by paragraph (2) of subsection (a), may not have any distributions qualify under subsection (b). If the first distribution under this part falls under subsection (b), no distribution may qualify under subsection (a). It is the intent of these subsections that a qualified bank holding corporation must determine whether it will dispose of prohibited property and remain a bank holding company or whether it will dispose of the property upon the basis of which the corporation is determined to be a bank holding company.

Subsection (c) of section 1101 is a limitation upon the application of subsections (a) and (b) Subparagraph (A) of paragraph (1) of subsection (c) specifically excludes from the application of subsections (a) and (b) of section 1101 any property which a qualified bank holding corporation acquired after May 15, 1955, except to the extent such corporation received such property (even though subsequent to May 15, 1955) and gain was not recognized by reason of subsection (a) or (b), or unless the property was received by the corporation in exchange for all of its stock in an exchange to which paragraph (2) or (3) of subsection (c) applies.

Under subparagraph (B) of paragraph (1), neither subsection (a) nor (b) of section 1101 is applicable to any distribution by a qualified bank holding corporation with respect to any stock which was acquired by the shareholder of such corporation after May 15, 1955, unless such shareholder receives such stock in a distribution the gain with respect to which was not recognized by reason of subsection (a) or (b).

Paragraph (2) of subsection (c) of section 1101 is an exception to the general rule of paragraph (1) of subsection (c) that subsections (a) and (b) do not apply to any property acquired by the distributing corporation after May 15, 1955. Under paragraph (2) if a qualified bank holding corporation exchanges solely property which, under subsection (a), such corporation could distribute directly to its shareholders without the recognition of gain to such shareholders, for all of the stock of a second corporation created and availed of solely for

the purpose of receiving such property, and immediately after the exchange, the qualified bank holding corporation distributes all of such stock to its shareholders with respect to its stock, then all of the stock of the second corporation may be distributed to the shareholders of such qualified bank holding corporation without recognition of gain. However, prior to such exchange the Board must certify that the exchange and distribution are necessary or appropriate to effectuate the first sentence of section 6(a) of the Bank Holding Company Act of 1955.

Paragraph (3) of subsection (c) of section 1101 is another exception to the general rule of paragraph (1) of subsection (c) that subsections (a) and (b) do not apply to any property acquired by the distributing corporation after May 15, 1955. Under paragraph (3) if any qualified bank holding corporation exchanges solely property which, under subsection (b), such corporation could distribute directly to its shareholders without the recognition of gain to such shareholders, for all of the stock of a second corporation created and availed of solely for the purpose of receiving such property and immediately after the exchange, the qualified bank holding corporation distributes all of such stock to its shareholders with respect to its stock, then all of the stock of the second corporation may be distributed to the shareholders of such qualified bank holding corporation without the recognition of gain. However, prior to such exchange the Board must have certified that such property is of a kind which causes such corporation to be a bank holding company, that the disposition of property of that kind is necessary to enable such corporation to cease being a bank holding company, and that the exchange and distribution are necessary or appropriate to effectuate the policies of the Bank Holding Company Act of 1955.

Under subsection (d) of section 1101 the nonrecognition of gain provided by subsection (a) or (b) shall not apply to that portion of any distribution which is attributable to any contribution to capital of any corporation made after May 15, 1955. Thus, assume that corporation A (a qualified bank holding corporation) owns all of the stock of corporation X (such stock being property falling within the provisions of subsection (a) of section 1101). Assume further that corporation A, after May 15, 1955, makes a contribution to the capital of corporation X in the amount of $50,000. Thereafter, corporation A makes a distribution to which subsection (a) of section 1101 applies of the stock of corporation X to the shareholders of corporation A. Under subsection (d), the nonrecognition of gain provided by subsection (a) does not apply to that portion of the distribution which is attributable to the contribution of capital, that is, $50,000. The amount of the distribution to the extent of the contribution to capital, $50,000, is a distribution subject to the provisions of section 301 of the Internal Revenue Code of 1954.

Paragraph (2) of subsection (d), however, provides an exception to the rule established in paragraph (1). Paragraph (2) provides that paragraph (1) shall not apply with respect to any contribution to capital of a bank if the Secretary or his delegate determines that the avoidance of Federal income tax was not one of the principal purposes for making such contributions.

Subsection (e) of section 1101 provides that neither subsection (a) nor subsection (b) shall apply with respect to any distribution by a corporation unless the Board makes the certification required by the subsection.

Paragraph (1) of subsection (e) relates to certification with respect to distributions falling within subsection (a). It provides that subsection (a) shall not apply to any such distribution unless the Board certifies that, before the expiration of the period permitted under section 6(a) of the Bank Holding Company Act of 1955 (including any extensions thereof granted to such corporation under such section 6(a)), the corporation has disposed of all the property, the disposition of which is necessary or appropriate to effectuate the first sentence of such section 6(a) (or would have been so necessary or appropriate if the corporation had continued to be a bank holding company). In order that subsection (a) of section 1101 is to apply to distributions of prohibited property by a qualified bank holding corporation, it is essential that such corporation dispose of all of the property which it is required to dispose of by reason of the Bank Holding Company Act of 1955, within the period (including extensions thereof) specified in section 6(a) of such act. During the period during which such corporation is required to dispose of all such property, distributions of prohibited property are to be considered as being within subsection (a) of section 1101, if other requirements of this part are met. Thus, no gain would be recognized to shareholders on distributions (if such distributions would otherwise qualify for the benefits of

this part) during such period. If, at the close of such period, the corporation has disposed of all of the property which it is required to dispose of by the Board and the Board has made the certification required under subsection (e) of section 1101, subsection (a) of section 1101 will apply to distributions of prohibited property. However, if, at the close of such period, the corporation has not disposed of all of the property the disposition of which is necessary or appropriate to effectuate the first sentence of section 6(a) of the Bank Holding Company Act of 1955, then subsection (a) of section 1101 will not apply to any distributions of prohibited property by the corporation. Thus, in a case where the provisions of subsection (e) (1) are not met, the tax treatment of any distribution of prohibited property by a qualified bank holding corporation to its shareholders is governed by the provisions of other sections of the Internal Revenue Code of 1954 applicable thereto.

Paragraph (2) of subsection (e) of section 1101 is applicable to distributions falling within subsection (b) of section 1101. Subparagraph (A) provides that subsection (b) shall not apply with respect to any distribution by any corporation unless the Board certifies that, before the expiration of 2 years after the enactment of this part, the qualified bank holding corporation has ceased to be a bank holding company. However, under subparagraph (B) the Board is authorized on the application of any qualified bank holding corporation to extend such period from time to time with respect to such corporation for not more than 1 year at a time if, in its judgment, such an extension would not be detrimental to the public interest. Such period may not in any case be extended beyond the date 5 years after the date of enactment of this part. In order that subsection (b) of section 1101 is to apply to distributions of property of a kind which causes a qualified bank holding corporation to be a bank holding company and the disposition of which is necessary to enable such corporation to cease being a bank holding company, it is essential that such corporation cease to be a bank holding company within the period (including extensions thereof) specified in subsection (e)(2) of section 1101. During the period during which such corporation disposes of property to enable it to cease being a bank holding company, distributions of such property are to be considered as being within subsection (b) of section 1101, if other requirements of this part are met. Thus, no gain would be recognized to shareholders on such distributions (if such distributions would otherwise qualify for the benefits of this part) during such period. If, at the close of such period specified in subsection (e)(2), the corporation has ceased to be a bank holding company, subsection (b) of section 1101 will apply to distributions of such property. However, if, at the close of such period, the corporation has not ceased being a bank holding company, then subsection (b) of section 101 will not apply to any distributions of such property by the corporation. Thus, in a case where the provisions of subsection (e)(2) are not met, the tax treatment of any distributions of property of a kind which causes a qualified bank holding corporation to be a bank holding company to its shareholders is governed by the provisions of other sections of the Internal Revenue Code of 1954 applicable thereto.

Section 1102 provides special rules for the application of this part.

Subsection (a) relates to the basis of property acquired in distributions under either subsection (a) or subsection (b) of section 1101. If gain is not recognized by reason of either of such subsections with respect to the receipt of any property, then the basis of such property and of the stock with respect to which it was distributed, shall, in the hands of the distributee, be determined by allocating the adjusted basis of such stock between such property and such stock. Such allocation shall be made under regulations prescribed by the Secretary or his delegate.

Subsection (b) of section 1102 relates to the periods of limitation. Under this subsection 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 not expire, with respect to any deficiency (including interest and additions to the tax) resulting solely from the receipt of property to which subsection (a) or (b) of section 1101 applies, before the date which is 1 year after the date on which the corporation notifies the Secretary or his delegate, that final certification by the Board with respect to the corporation from which such property was received has been made under section 1101(e); 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. Thus, if the Board does not make the certification provided in subsection (e) (1) or (2), the periods of

limitation provided in sections 6501 and 6502 will not prohibit the making of an assessment or collection by levy or proceeding in court with respect to any deficiency for prior taxable years resulting solely from receipt of property which would otherwise fall within subsections (a) or (b) of section 1101.

Subsection (c) of section 1102 relates to allocation of earnings and profits. In case of any exchange described in section 1101(c)(2) or (3), the earnings and profits of the corporation transferring the property shall be properly allocated between such corporation and the corporation receiving such property under regulations prescribed by the Secretary or his delegate.

Subsection (d) relates to itemization of property distributed. The Board is required in any certification under this part to make such specification and itemization of property as may be necessary to carry out the provisions of this part.

Section 1103 sets forth the definitions, for purposes of this part, of "bank holding company," "qualified bank holding corporation," "prohibited property," "nonexempt property," and "Board."

Subsection (a) of this section provides that the term "bank holding company" means a bank holding company as defined by section 3 of the Bank Holding Company Act of 1955.

Subsection (b) of this section defines the term "qualified bank holding corporation." In order for a corporation to be a qualified bank holding corporation, and therefore for its shareholders to receive the special tax treatment provided by this part, it must not only be a bank holding company but in addition, it must hold "prohibited property" as defined in subsection (c). For example, if the sole assets of corporation X consist of 25 percent of the voting shares of each of 2 banks, corporation X is not a qualified bank holding corporation.

In addition, to be a qualified bank holding corporation the prohibited property must have been acquired on or before May 15, 1955, by a corporation which is a bank holding company, or must have been acquired in a distribution to it by a qualified bank holding corporation with respect to which gain is not recognized by reason of section 1101(a). Furthermore, a bank holding company which holds prohibited property acquired by it in exchange for all of its stock in an exchange described in section 1101(c)(2) is a qualified bank holding corporation.

The preceding paragraph may be illustrated by the following examples. (1) If the sole assets of corporation X on May 15, 1955, consist of cash and 25 percent of the voting shares of each of 2 banks and on May 30, 1955, corporation X purchases nonbanking business assets, corporation X is not a qualified bank holding corporation. (2) The sole assets of corporation Y, on May 15, 1955, consist of 25 percent of the voting shares of each of 2 banks and 4 percent of the outstanding voting securities (the value of which is less than 5 percent of the value of corporation Y's) total assets of corporation Z, a qualified bank holding corporation. Corporation Z distributes nonbanking business assets to corporation Y which are prohibited property in the hands of corporation Y, in a distribution to which section 1101(a) applies. Corporation Y becomes a qualified bank holding corporation by reason of the distribution by Z. (3) On May 15, 1955, corporation B owns all of the stock of corporation A, a qualified bank holding corporation on such date. Corporation B, a qualified bank holding corporation by virtue of its ownership of the stock of corporation A, transfers such stock to corporation C in an exchange meeting the requirements of section 1101(c)(2). Corporation C is a qualified bank holding corporation.

Notwithstanding that a corporation meets the requirements of paragraph (1) of subsection (b), such corporation shall not be a qualified bank holding corporation unless it meets the additional requirements of subparagraphs (A), (B), and (C) of paragraph (2).

Subparagraph (A) of paragraph (2) provides that a bank holding company shall not be a qualified bank holding corporation unless such corporation would have been a bank holding company on May 15, 1955, if the Bank Holding Company Act of 1955 had been in effect on such date, or unless such corporation is a bank holding company determined solely by reference to the following: (1) Property acquired by such corporation on or before May 15, 1955; (2) property acquired by such corporation in a distribution by a qualified bank holding corporation to such corporation wherein gain was not recognized by reason of subsection (a) or (b) of section 1101; and (3) property acquired by such corporation in exchange for all of its stock in an exchange meeting the requirements of section 1101(c)(2) or (3).

Thus, if on May 15, 1955, the sole assets of corporation X consist of cash and business assets and on May 30, 1955, corporation X acquires 25 percent of the voting shares of each of 2 banks for cash, then, by reason of subparagraph (A) of paragraph (2), corporation X, although a bank holding company, holding prohibited property acquired by it before May 15, 1955, is not a qualified bank holding corporation. An additional example of the application of subparagraph (A) of paragraph (2) is where corporation X is determined, by the Board, after May 15, 1955, to be a bank holding company by reason of clause (2) of section 3(a) of the Bank Holding Company Act of 1955, solely by reference to (1) property acquired by such corporation on or before May 15, 1955, and (2) property acquired by it from a qualified bank holding corporation in a distribution in which gain to the distributee was not recognized by reason of subsection (a) or (b) of section 1101.

Except as explained in the next paragraph, subparagraph (B) of paragraph (2) provides that a bank holding company shall not be a qualified bank holding corporation by reason of either (1) the acquisition by such bank holding company of prohibited property after May 15, 1955, in a distribution from a qualified bank holding corporation to which section 1101(a) is applicable or (2) the acquisition by such bank holding company (which company would not have been a bank holding company on May 15, 1955, if the Bank Holding Company Act of 1955 had been in effect on such date) of property described in clause (ii) of subparagraph (A) of paragraph (2). An example of the operation of the foregoing is where, on May 15, 1955, the sole assets of corporation Y consist of cash and 25 percent of the voting shares of each of two banks. On May 30, 1955, corporation Y purchases for cash 50 percent of the stock of corporation Z, a qualified bank holding corporation. Corporation Z distributes business assets to corporation Y in a distribution in which gain to corporation Y with respect to the receipt of such property was not recognized by reason of section 1101(a). Corporation Y is not a qualified bank holding corporation since such property was acquired by corporation Y in a distribution with respect to stock acquired after May 15, 1955.

A bank holding company may be a qualified bank holding corporation by reason of the property described in the preceding paragraph if such property was acquired in a distribution with respect to stock which was acquired by such company (1) on or before May 15, 1955, (2) in a distribution (with respect to stock held by it on May 15, 1955, or with respect to stock in respect of which all previous applications of this clause are satisfied) with respect to which gain to it was not recognized by reason of subsection (a) or (b) of section 1101, or (3) in exchange for all of the stock of the bank holding company in an exchange meeting the requirements of section 1101(c)(2) or (3).

Subparagraph (C) of paragraph (2) states that a corporation may not be treated as a qualified bank holding corporation unless the Board certifies that it satisfies the requirements of subsection (b) of section 1103.

Subsection (c) of section 1103 defines the term "prohibited property." Such property is defined as property, other than nonexempt property, the disposition of which, in the case of any bank holding company, would be necessary or appropriate to effectuate the first sentence of section 6(a) of the Bank Holding Company Act of 1955, if such company continued to be a bank holding company beyond the period (including any extensions thereof) specified in section 6(a), in the case of distributions under section 1101(a), or specified in section 1101(e)(2)(B), in the case of distributions under section 1101(b). The term "prohibited property" does not include shares, securities, or obligations of any company which are held by a bank holding company to the extent that the ownership by such bank holding company of such property is not prohibited by section 6 of such act by reason of subsection (c)(6) of such section.

Subsection (d) defines the term "nonexempt property," the distribution of which may not be accorded the tax treatment provided by this part.

Subsection (e) of this section states that the term "Board" means the Board of Governors of the Federal Reserve System.

Subsection (g) amends the Investment Company Act of 1940, as amended, and the Investment Advisers Act of 1940, as amended, so as to exclude from those acts, bank holding companies as defined in the Bank Holding Company Act of 1955 rather than as defined in the Banking Act of 1933. The subsection also excludes from the Investment Company Act of 1940 and the Investment Advisers Act of 1940 any banking subsidiary or other subsidiary of a bank holding company if such subsidiary is exempt from the provisions of section 6 of the Bank Holding Company Act of 1955 by reason of the provisions of section 6(c)(1) of that act.

[H. R. 6712—P. L. 495]

AMENDING SECTION 1237 OF THE INTERNAL REVENUE CODE OF 1954

[House of Representatives Report No. 1608, Eighty-fourth Congress, First Session]

[July 30, 1955]

Mr. Boggs, from the Committee on Ways and Means, submitted the following report [To accompany H. R. 6712]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 6712) to amend section 1237 of the Internal Revenue Code of 1954, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE OF BILL

This bill amends section 1237 of the Internal Revenue Code of 1954 relating to real property subdivided for sale. Under this bill the capital-gains treatment generally granted by section 1237 is extended to certain corporations and other taxpayers who may not qualify under the present section. This bill also allows taxpayers under certain circumstances to make public-utility improvements on the property that is within the scope of this section.

GENERAL STATEMENT

Prior to the enactment of the 1954 Code when a taxpayer subdivided real property for sale, he was likely to be considered as holding the property for sale to customers in the ordinary course of a trade or business and subjected to ordinary income treatment. Section 1237 provided relief in a limited area by providing special rules for the taxation of gain from the sale of real property coming within the scope of the section. The section provides that the taxpayer is not to be considered as holding property primarily for sale customers in the ordinary course of trade or business "soley" because he subdivided the tract for purposes of sale or because of any activity incident to the subdivision or sale if the property came within the scope of the section. If the taxpayer could be considered a dealer in real property because of his transactions involving other property, the property would still be considered as held for sale to customers in the ordinary course of trade or business.

EXPLANATION OF BILL

Under the 1954 Code, section 1237 is limited to real property "in the hands of a taxpayer other than a corporation." The first section of this bill extends the scope of the section to include corporations if no shareholder directly or indirectly holds real property for sale to customers in the ordinary course of trade or business. Thus, in the case of a corporation neither the corporation nor any shareholder may be a real-estate dealer.

The second section of this bill allows certain property to come within the scope of section 1237 although the taxpayer has made improvements on the property. Under section 1237(a)(2) of present law, property is not to qualify if the taxpayer (as defined in section 1237(a)) has made a substantial improvement on the tract of land that substantially enhances the value of the lot or parcel sold. The subparagraphs of subsection (b)(3) of present law provide that no improvement is to 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 the taxpayer satisfies certain conditions. Subparagraph (A) provides that the improvement must constitute the building or installation of water or sewer facilities or roads. Subparagraph (B) provides that it must be 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. Subparagraph (C) provides that the taxpayer must elect in accordance with regulations prescribed by the Secretary or his delegate to make no adjustment to the lot or parcel, or of any other property owned by the taxpayer, on account of the expenditures of such improvements.

This bill amends subsection (b) (3) to provide that the taxpayer may install "other public utilities" as well as those listed in the present paragraph (3) (A). The bill also provides that in determining whether or not an improvement is to be considered a substantial improvement, the requirements of subparagraphs (B) and (C) described above are not to apply in the case of property acquired through the foreclosure of certain liens. The lien must have secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of its stock and other consideration and in the case of property adjacent to such property if 80 percent of the real property owned by the taxpayer is property acquired in the manner described above.

Your committee has reported this bill unanimously.

[H. R. 6712—P. L. 495]

AMENDING SECTION 1237 OF THE INTERNAL REVENUE CODE OF 1954

[Senate Report No. 1705, Eighty-fourth Congress, Second Session. Calendar No. 1730]

[March 22 (legislative day, March 19), 1956]

Mr. Long, from the Committee on Finance, submitted the following report [To accompany H. R. 6712]:

The Committee on Finance, to whom was referred the bill (H. R. 6712) to amend section 1237 of the Internal Revenue Code of 1954, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 1, line 7, strike out "business" and insert "business and only in the case of property described in the last sentence of subsection (b) (3)".

Page 1, strike out subsection (a) of section 2 and insert: (a) In subparagraph (A) strike out "water or sewer facilities" and insert: "water, sewer, or drainage facilities".

PURPOSE OF BILL

This bill amends section 1237 of the Internal Revenue Code of 1954 relating to real property subdivided for sale. Under this bill the capital-gains treatment generally granted by section 1237 is extended to certain corporations and other taxpayers in the case of land acquired directly (or indirectly in the manner provided) through foreclosure and held for more than 10 years although the taxpayer may have installed water, sewer, or drainage facilities or roads.

General Statement

Prior to the enactment of the 1954 Code when a taxpayer subdivided real property for sale, he was likely to be considered as holding the property for sale to customers in the ordinary course of a trade or business and subjected to ordinary income treatment. Section 1237 provided relief in a limited area by providing special rules for the taxation of gain from the sale of real property coming within the scope of the section. The section provides that the taxpayer is not to be considered as holding property primarily for sale to customers in the ordinary course of trade or business "solely" because he subdivided the tract for purposes of sale or because of any activity incident to the subdivision or sale if the property came within the scope of the section. If the taxpayer could be considered a dealer in real property because of his transactions involving other property, the property would still be considered as held for sale to customers in the ordinary course of trade or business. However, a determination that a taxpayer is a dealer in real estate must be predicated upon all the facts and circumstances surrounding the transaction or transactions in question and the fact that a corporate taxpayer's charter permits or prohibits trading in real estate would not of itself be contolling. For purposes of section 1237, property will not be regarded as held for sale to customers solely because of real-estate development and sales activity, relating to the tract, that is within the scope of section 1237. This bill enlarges the scope of section 1237 primarily with regard to property that is acquired through foreclosure.

EXPLANATION OF BILL

This bill allows certain property to come within the scope of section 1237 although the taxpayer has made improvements on the property. Under section 1237 (a)(2) of present law, property is not to qualify if the taxpayer (as defined in sec. 1237 (a) has made a substantial improvement on the tract of land that substantially enhances the value of the lot or parcel sold. The subparagraphs of subsection (b)(3) of present law provide that no improvement is to 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 the taxpayer satisfies certain conditions. Subparagraph (A) provides that the improvement must constitute the building or installation of water or sewer facilities or roads. Subparagraph (B) provides that it must be 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. Subparagraph (C) provides that the taxpayer must elect in accordance with regulations prescribed by the Secretary or his delegate to make no adjustment to the lot or parcel, or of any other property owned by the taxpayer, on account of the expenditures of such improvements.

This bill amends subsection (b)(3) to provide that the taxpayer may install "drainage facilities" as well as those listed in the present paragraph (3)(A). The bill also provides that in determining whether or not an improvement is to be considered a substantial improvement, the requirements of subparagraphs (B) and (C) described above are not to apply in the case of property acquired through the foreclosure of certain liens and property adjacent to such property if 80 percent of the real property owned by the taxpayer is property acquired through foreclosure as described in paragraph (3). The lien must have secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of its stock and other consideration.

Under the 1954 Code, section 1237 is limited to real property "in the hands of a taxpayer other than a corporation." This bill extends the scope of the section to include corporations in the case of land acquired through foreclosure and adjacent property (as described in the last sentence of subsection (b)(3)).

Your committee has made two amendments in the bill as passed by the House of Representatives. Under the House bill, the benefits of section 1237 would have been extended to corporations on the same basis as individuals in all cases if no shareholder of the corporation was a real-estate dealer. It was pointed out that this provision would be difficult to administer, and your committee has amended the bill to permit corporations to qualify only if the corporation is holding property originally acquired through foreclosure of a lien thereon. This would include a corporation to which was transferred the foreclosure bid in exchange for all of its stock and other consideration or a corporation was itself the creditor.

The second amendment made by your committee removes a reference in the bill to "other public utilities" and substitutes "drainage facilities." This will narrow the scope of the House bill by limiting the types of improvements that the taxpayer may make and remain within the scope of section 1237.

This bill is applicable to all taxable years beginning after December 31, 1954.

[H. R. 7030—P. L. 545]

REVISION AND EXTENSION OF SUGAR ACT OF 1948

[House of Representatives Report No. 1348, Eighty-fourth Congress, First Session] [4]

[JULY 22, 1955]

Mr. Cooley, from the Committee on Agriculture, submitted the following report [To accompany H. R. 7030]:

The Committee on Agriculture, to whom was referred the bill (H. R. 7030) to amend and extend the Sugar Act of 1948, as amended, and for other purposes,

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[4] This publication of the committee report is restricted to excerpts involving internal revenue matters.

having considered the same, report favorably thereon with amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike out all after the enacting clause and insert:

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SEC. 21. Sections 4501(c) and 6412(d) (relating to the termination of taxes on sugar) of the Internal Revenue Code of 1954 are amended by striking out "1957" in each place it appears therein and inserting in lieu thereof "1961".

SEC. 22. Section 4502(4), chapter 4, subchapter A, "Sugar", of the Internal Revenue Code of 1954 is amended as follows: Strike out the parenthetical word "(Clerget)" where it occurs in the first sentence and delete the second sentence thereof.

SEC. 23 (a) Section 4504, chapter 37, subchapter A, "Sugar", of the Internal Revenue Code of 1954 is amended by adding before the period at the end thereof the following: "and except that such tax may be subject to refunds as a tax under the provisions of section 6418(a)".

(b) Section 6418(a) of chapter 65 of the Internal Revenue Code of 1954 is amended by striking out the "(a)" immediately following "section 4501".

SEC. 24. The amendments made hereby shall become effective January 1, 1956, except as otherwise designated and except that required determinations and regulations may be issued in 1955 for the calendar year 1956.

MAJOR PROVISIONS

H. R. 7030 reenacts and extends for 4 years, to December 31, 1960, the Sugar Act of 1948, as amended, with further amendments dealing primarily with adjustments of quotas intended to give domestic producers a fair share in the growth of the United States sugar market and to bring about an equitable participation by foreign suppliers in this market. The present act, in the absence of any action by the Congress, would expire December 31, 1956.

The bill also extends for 4 years, to June 30, 1961, the applicability of the excise tax on sugar in the Internal Revenue Code. This tax finances the sugar-stabilization program. This legislation's major effect is to open the way for United States domestic area producers to participate with foreign areas in supplying the growth of the United States sugar market.

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NATIONAL POLICY

For many years it has been the policy of the United States Government—for defense and strategic reasons—to preserve within the United the ability to produce a portion of our sugar requirements. This has been done because sugar is an essential and vital food product needed by American consumers, the supply of which on a worldwide scale has been marked by periods of alternating scarcity and surplus.

A large portion of the world's sugar production is grown in tropical countries with essentially one-crop economies, where cheap labor is abundantly available and cannot be utilized in other enterprises. An additional large portion is distributed among the majority of the countries of the world which, like the United States, provide protection to their sugar industries. In these circumstances, it is unlikely that a significant amount of sugar would be grown in the continental United States if American producers had to compete on the open world market with sugar produced with cheap tropical labor.

For many years, protection was afforded to our sugar producers solely through the tariff. Although the tariff did assist domestic producers, it still left them exposed to the price fluctuations of the world sugar market. It also increased the price of sugar to consumers in the United States without assuring them of adequate foreign sources of supply in case of emergencies.

A quota system which prorated domestic consumption among producers in the United States and a number of foreign countries was developed and enacted as law in 1934. The quota system was revised in 1937 and again in the present act which became effective in 1948 and was amended in 1951, effective as of January 1, 1953. Since initiation of the quota system, the tariff on sugar has been reduced 75 percent and now represents only supplementary protection to the sugar industry.

A tax of 0.5 cent per pound is imposed on all sugar manufactured or imported into the United States. Payments are made to domestic producers of sugarcane or sugar beets at a rate which ranges from 80 cents per hundredweight of recoverable sugar produced on small farms to as little as 30 cents per hundredweight of production in excess of 30,000 tons of sugar on large farms. To qualify for payments under the program, producers must comply with production restrictions, pay fair wages to workers, and not employ child labor and, if they are also processors, pay fair prices for sugarcane or sugar beets.

Income to the Government from the tax on sugar has been very substantially in excess of the amount disbursed as payments to domestic growers during each of the years under the program. In recent years the income from the excise or import compensating tax has approximated $80 million annually, while payments to growers have approximated $65 million.

In the last 18 years there has been a net return to the Treasury of over $300 million in the difference between collections on the sugar excise tax and the actual cost of the stabilization program.

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ANALYSIS OF THE BILL

Definitions

The amendments contained in sections 1 through 4 of the bill revise some of the definitions contained in title I of the Sugar Act of 1948, as amended. In general, these amendments are for the purpose of clarifying definitions in a manner such that their literal wording will be in keeping with the intent of the act, and to provide more specific instructions for administering those provisions of the act dependent upon definitions.

The first and second sections of the bill amend subsections (d) and (e) of section 101 of the act. Subsection (d) defines raw sugar and subsection (e) defines direct-consumption sugar. The amendments clarify the present definitions with respect to the classification for quota purposes of liquid sugar from domestic areas as either raw or direct-consumption sugar. (The wording of the present definitions is such that liquid sugar cannot technically be classified as either raw or direct-consumption sugar. Consequently, a literal interpretation of the present definitions would permit liquid sugar of refined quality from domestic off-shore areas to enter under the overall quotas without regard to the direct-consumption limitations.) The amendments to subsections (d) and (e) provide that liquid sugar from domestic areas would be classified as either raw or direct-consumption sugar in accordance with the same principle that is applied to the quota classification of crystalline sugar. The amendments specifically exclude from such classification liquid sugar from foreign countries inasmuch as liquid sugar entries from such areas are limited by fixed quotas.

Section 3 of the bill amends subsection (i) of section 101 of the act by striking out the parenthetical word "(Clerget)". The word "Clerget" refers to an analytical method and its deletion does not affect the meaning of the term "total sugar content" which is defined in subsection (i). Its deletion in the amendment, however, does relieve the Secretary of Agriculture of requiring the use of a method (the Clerget method) for determining sucrose in the measurement of total sugar content, which is not the most accurate method for the conditions under which its use is prescribed. The amendment permits the Secretary to specify more accurate methods for such determinations.

Section 4 of the bill adds a new subsection (n) to section 101 of the act. The amendment defines the term "to be further refined or improved in quality", which is contained in both the raw and the direct-consumption sugar definitions and is a criterion for distinguishing raw from direct-consumption sugar for quota purposes. The definition of the term "to be further refined or improved in quality" basically establishes the minimum processing to which sugar must be subjected before it can be classified as raw sugar. In the event that there is any question as to the processes to which raw sugar is to be subjected or as to the quality of the sugar being processed, the amendment also provides the Secretary of Agriculture with authority to hold hearings to determine whether specific processes to which sugar is subjected meet the requirements of the standards established by the amendment or whether sugar processed is of raw or direct-consumption sugar quality. The amendment gives clearer guidance to the Secretary of Agriculture in administering those provisions of the act, which require him to classify sugar as raw or direct-consumption for making the proper quota charges. The amendment permits the Secretary to consider the type and

extent of processing and the quality of sugar in addition to the use criterion contained in subsections (d) and (e) in distinguishing raw sugar from direct-consumption sugar.

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Periods for which bill is effective

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Section 21 extends to June 30, 1961, the period during which the excise and import compensating tax is applicable to sugar.

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Amendments to the Internal Revenue Code

Section 22 of the bill amends section 4502(4) of the 1954 Internal Revenue Code. That section of the Internal Revenue Code defines the term "total sugars" similarly to the term "total sugar content" contained in section 101(i) of the Sugar Act and in addition makes reference to Customs Regulations of 1930, which have since been superseded. The amendment in no way affects the meaning of the term "total sugars" and permits the Treasury Department to use methods that are most appropriate to the determination of total sugars.

Section 23 of the bill amends section 4504 and 6418(a) of the Internal Revenue Code of 1954. The amendments provide that the import compensating tax on manufactured sugar imported into the United States for use in the distillation of alcohol or for livestock feed may be refunded. Section 212 of the Sugar Act exempts from quota control any sugar or liquid sugar used for such purposes. However, tax exemption under the Internal Revenue Code has been only partly consistent with the quota exemption. The processing tax (applicable to sugar manufactured in the United States) has been refundable on sugar used for livestock feed or for the distillation of alcohol, but the import compensating tax (applicable to manufactured sugar imported into the United States) has not been refundable on sugar used for the same purpose. The amendment provides that either the processing tax or the import compensating tax, whichever is applicable, may be refunded on sugar used for livestock feed or for the distillation of alcohol.

[H. R. 7030—P. L. 545]

EXTENSION OF SUGAR ACT OF 1948

[Senate Report No. 1461, Eighty-fourth Congress, Second Session. Calendar No. 1482] [5]

[January 26 (legislative day, January 16, 1956)]

Mr. Byrd, from the Committee on Finance, submitted the following report [To accompany H. R. 7030]:

The Committee on Finance, to whom was referred the bill (H. R. 7030) to amend and extend the Sugar Act of 1948, as amended, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

MAJOR PROVISIONS

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In view of the long-term commitments and planning necessary for the efficient operation of the sugar-producing industry, the committee feels that a 6-year extension is desirable. The House bill provided for a 4-year extension. The bill as reported by the committee also extends the termination date of taxes under the Internal Revenue Code for 6 years.

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ANALYSIS OF THE BILL

Definitions

Sections 1 through 4 of the bill amend certain definitions contained in title I of the Sugar Act of 1948, as amended. In general, these amendments clarify the

[5] This publication of the committee report is restricted to excerpts involving internal revenue matters.

definitions to coincide with the evident intent of the act. In addition, the amendment provides more specific instructions for administering those provisions of the act dependent upon definitions.

The first and second sections of the bill amend subsections (d) and (e) of section 101 of the act. Subsections (d) and (e) define raw sugar and direct-consumption sugar, respectively. The wording of the present definitions is such that it is doubtful whether some liquid sugar from domestic offshore areas should be classified as either raw or direct-consumption sugar, although a literal interpretation of the present definitions would permit liquid sugar of refined quality from domestic offshore areas to enter within the overall quotas without regard to the direct-consumption limitations. The amendments to these two subsections clarify the present definitions to permit the classification for quota purposes of liquid sugar from domestic offshore areas as either raw or direct-consumption sugar. Such classification is in accordance with the principle that is applied to the classification of crystalline sugar. The amendments are intended to exclude from the raw and direct consumption definitions liquid sugar from all foreign countries. Liquid sugar entries from such countries are limited by sections 208 and 212 of the act. The amended definitions of raw and direct-consumption sugar are supplemented by, and are to be read in the light of, the provisions of the new subsection (n).

Section 3 of the bill amends subsection (i) of section 101 of the act by striking out the parenthetical word "(Clerget)." The word "Clerget" refers to an analytical method and its deletion does not affect the meaning of the term "total sugar content" which is defined in subsection (i). Its deletion in the amendment, however, eliminates the requirement of the use of a method (the Clerget method) for determining sucrose in the measurement of total sugar content. The amendment permits the utilization of newer and more accurate methods for such determinations.

Section 4 of the bill adds a new subsection (n) to section 101 of the act. The amendment defines the term "to be further refined or improved in quality," which is contained in both the raw and direct-consumption sugar definitions and which is a criterion for distinguishing raw from direct-consumption sugar for quota purposes. The definition of the term "to be further refined or improved in quality" basically establishes the minimum processing to which sugar must be subjected before it can be classified as raw sugar. In the event there is any question as to the processes to which raw sugar is to be subjected or as to the specific qualities of sugar which may be so processed, the amendment also provides the Secretary with authority to hold hearings to determine whether specific processes to which sugars are subjected meet the requirements of the standards established by the amendment or whether sugars of specific qualities are of raw or direct-consumption sugar quality. The amendment gives clearer guidance to the Secretary in administering those provisions of the act, which requires him to classify sugar as raw or direct consumption for making the proper quota charges. The amendment permits the Secretary to consider the type and extent of processing and the quality of sugar in addition to the use criterion contained in subsections (d) and (e) in distinguishing raw sugar from direct-consumption sugar.

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Administrative provisions

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Section 19 extends to June 30, 1963, the period during which the excise and import compensating tax is applicable to sugar.

Section 22 of the bill provides that the amendments shall become effective January 1, 1956, except as otherwise provided. In particular, sections 1 through 4 will become effective upon implementation by publication of regulations in the Federal Register or 6 months after the date of enactment of this bill into law, whichever is earlier.

Amendments to the Internal Revenue Code

Section 20 of the bill amends section 4502(4) of the 1954 Internal Revenue Code. That section of the code defines the term "total sugars" similarly to the term "total sugar content" contained in section 101 (i) of the act and refers to Customs Regulations of 1930, which have since been superseded. The amendment in no way affects the meaning of the term "total sugars" and permits the Treasury Department to use methods that are most appropriate to the determination of total sugars.

Secion 21 of the bill amends section 4505 and 6418(a) of the Internal Revenue Code of 1954. The amendments provide that the import compensating tax on manufactured sugar imported into the United States for use in the distillation of alcohol or for livestock feed may be refunded. Section 212 of the sugar act exempts from quotas any sugar or liquid sugar used for such purposes. However, tax exemption under the Internal Revenue Code has been only partly consistent with the quota exemption. The excise tax applicable to sugar manufactured in the United States has been refundable on sugar used for livestock feed or for the distillation of alcohol, but the import compensating tax applicable to manufactured sugar imported into the United States has not been refundable on sugar used for the same purpose. The amendment provides that either the excise tax or the import compensating tax, whichever is applicable, may be refunded on sugar used for livestock feed or for the distillation of alcohol.

[H. R. 7030—P. L. 545]

EXTENSION OF SUGAR ACT OF 1948

[House of Representatives Report No. 2174, Eighty-fourth Congress, Second Session] *

[May 16, 1956]

Mr. Cooley, from the committee of conference, submitted the following conference report [to accompany H. R. 7030]:

The committee of conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H. R. 7030) to amend and extend the Sugar Act of 1948, as amended, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their *amended to read as follows:*

That the House recede from its disagreement to the amendment of the Senate and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *That section 101(d) of the Sugar Act of 1948, as amended, is amended to read as follows:*

"*(d) The term 'raw sugar' means any sugars (exclusive of liquid sugar from foreign countries having liquid sugar quotas), whether or not principally of crystalline structure, which are to be further refined or improved in quality to produce any sugars principally of crystalline structure or liquid sugar.*"

SEC. 2. *Section 101 (e) of such Act is amended to read as follows:*

"*(e) The term 'direct-consumption sugar' means any sugars principally of crystalline structure and any liquid sugar (exclusive of liquid sugar from foreign countries having liquid sugar quotas), which are not to be further refined or improved in quality.*"

SEC. 3. *Section 101 (i) of such Act is amended by deleting the parenthetical word "(Clerget)".*

SEC. 4. *Section 101 of such Act is amended by adding at the end thereof a new paragraph to read as follows:*

"*(n) The term 'to be further refined or improved in quality' means to be subjected substantially to the processes of (1) affination or defecation, (2) clarification, and (3) further purification by adsorption or crystallization. The Secretary is authorized, after such hearing and upon such notice as he may by regulations prescribe, to determine whether specific*

* * * * * *

SEC. 19. *Sections 4501(c) and 6412(d) (relating to the termination of taxes on sugar) of the Internal Revenue Code of 1954 are amended by striking out "1957" in each place it appears therein and inserting in lieu thereof "1961".*

SEC. 20. *Section 4502(4), chapter 37, subchapter A, "Sugar", of the Internal Revenue Code of 1954 is amended as follows: Strike out the parenthetical word "(Clerget)" where it occurs in the first sentence and delete the second sentence thereof.*

SEC. 21. *(a) Section 4504, chapter 37, Subchapter A, "Sugar", of the Internal Revenue Code of 1954 is amended by adding before the period at the end thereof the following: ", and except that such tax may be subject to refunds as a tax under the provisions of section 6418(a)".*

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* This publication of the committee report is restricted to excerpts involving internal revenue matters.

(b) Section 6418(a) of chapter 65 of the Internal Revenue Code of 1954 is amended by striking out the "(a)" immediately following "section 4501".

SEC. 22. *Except as otherwise provided, the amendments made hereby shall become effective as of January 1, 1956, except that sections 1 through 4 shall become effective upon publication in the Federal Register of regulations implementing such sections, or six months after the date of enactment of this Act, whichever is earlier.*

And the Senate agree to the same.

HAROLD D. COOLEY,
W. R. POAGE,
E. C. GATHINGS,
T. G. ABERNETHY,
CLIFFORD R. HOPE,
AUG. H. ANDRESEN,
WILLIAM S. HILL,
Managers on the Part of the House.
HARRY FLOOD BYRD,
WALTER F. GEORGE,
ROBT. S. KERR,
E. D. MILLIKIN,
WALLACE F. BENNETT,
Managers on the Part of the Senate.

STATEMENT OF MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H. R. 7030) to amend and extend the Sugar Act of 1948, as amended, and for other purposes, submit the following statement in explanation of the effect of the action agreed upon and recommended in the accompanying conference report:

The Senate amendment struck out all after the enacting clause of the House bill and substituted new language which was in many respects identical with that adopted by the House and differed from the House provisions on only four major points: (1) the length of the extension of the Sugar Act, (2) the proportion of the increased demand in the United States allocated to foreign and to domestic producers, (3) the manner in which the domestic share of this increase is to be distributed among various domestic producing areas, and (4) the division of the foreign share of the growth in consumption among the producing countries. Following is the manner in which these major differences were resolved by the committee of conference:

(1) The Senate conferees receded on the length of the extension of the act and agreed to the 4-year period in the House bill rather than the 6-year extension passed by the Senate.

* * * * * * *

HAROLD D. COOLEY,
W. R. POAGE,
E. C. GATHINGS,
T. G. ABERNETHY,
CLIFFORD R. HOPE,
AUG. H. ANDRESEN,
WILLIAM S. HILL,
Managers on the Part of the House.

[H. R. 7036—P. L. 398]

AMENDING SECTION 37 OF THE INTERNAL REVENUE CODE OF 1954

[House of Representatives Report No. 1595, Eighty-fourth Congress, First Session]

[July 29, 1955]

Mr. Mason, from the Committee on Ways and Means, submitted the following report [to accompany H. R. 7036]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 7036) to amend section 37 of the Internal Revenue Code of 1954 so as to conform

its provisions respecting retirement income tax credit to the corresponding liberalized provisions of the Social Security Amendments of 1954, and to extend its provisions to members of the Armed Forces, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Strike out all after the enacting clause and insert:

That section 37(d)(2) of the Internal Revenue Code of 1954 (relating to limitation on retirement income) is hereby amended to read as follows:

"(2) in the case of any individual who has not attained the age of 72 before the close of the taxable year, any amount of earned income (as defined in subsection (g))—

"(A) in excess of $900 received by the individual in the taxable year if such individual has not attained the age of 65 before the close of the taxable year; or

"(B) in excess of $1,200 received by the individual in the taxable year if such individual has attained the age of 65 before the close of the taxable year."

SEC. 2. The amendment made by the first section of this Act shall apply only with respect to taxable years beginning after December 31, 1955.

Amend the title so as to read:

A bill to amend section 37 of the Internal Revenue Code of 1954 with respect to the earned income limitation on retirement income.

PURPOSE OF BILL

This bill, as reported, liberalizes the retirement income credit provided in section 37 of the Internal Revenue Code of 1954 so that the "earnings test" under this provision corresponds with the "work test" under the social-security laws.

GENERAL STATEMENT

Under section 37 of the 1954 code, an individual who is 65 years of age or over is granted a credit against his tax liability equivalent to the tax, at the first bracket rate, on the amount of his retirement income up to $1,200. This same retirement income credit is extended to those under age 65 with respect to pensions or similar payments received from public retirement systems other than military retirement systems (although this later restriction is removed in H. R. 291 which has been passed by both Houses of Congress). Section 37 of the 1954 code also permits an individual to earn up to $900 a year as an employee or in self-employment without affecting the amount of the retirement credit. However, earnings in excess of $900, in the case of an individual under age 75 reduce, dollar for dollar, the $1,200 maximum for retirement income. For those aged 75 and over there is no earned income limitation.

H. R. 7036, as reported, amends section 37 (d) (2) to increase from $900 to $1,200 the amount that an individual can earn without reducing the $1,200 on which the retirement credit is computed. The age at which there will be no limitation upon the amount of earned income, also in subsection (d) (2), is reduced from 75 to 72. The amendments made by the bill apply only to taxable years beginning after December 31, 1955.

The age limit of 75 for the waiving of the "earnings test" and the exclusion of the first $900 from the application of this test were designed to correspond to the then existing old-age and survivors insurance program. Benefits under that program, at the time the retirement income provision was considered last year, were reduced for earnings in excess of $900 and for those age 75 and over there was no work test. The House report on the 1954 code with respect to the retirement income provision stated:

Since the benefit of the credit is intended for retired individuals, the bill employs substantially the same test of retirement as that adopted for social-security purposes.

However, in the Social Security Amendments of 1954, passed by Congress after the enactment of the 1954 code, the amount of earned income excluded, in determining whether social-security benefits were to be reduced, was raised from $900

to $1,200 and the work test was made inapplicable to those age 72 and over, rather than to those age 75 and over. Thus, the changes made in this bill in the case of the retirement income credit merely conform to the changes made in the Social Security Amendments of 1954.

Since social-security benefits presently are not available to those under age 65, this bill raised the earnings test from $900 to $1,200 only for those age 65 to age 72.

It is estimated that this bill as amended will reduce revenues by about $11 million a year.

This bill has been reported unanimously by your committee.

[H. R. 7036—P. L. 398]

AMENDING SECTION 37 OF THE INTERNAL REVENUE CODE OF 1954 WITH RESPECT TO THE EARNED INCOME LIMITATION ON RETIREMENT INCOME

[Senate Report No. 1377, Eighty-fourth Congress, First Session. Calendar No. 1397]

[January 12, 1956]

Mr. Byrd, from the Committee on Finance, submitted the following report [to accompany H. R. 7036]:

The Committee on Finance, to whom was referred the bill (H. R. 7036) to amend section 37 of the Internal Revenue Code of 1954 with respect to the earned income limitation on retirement income, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

By virtue of this action, the Committee on Finance accepts the report of the Committee on Ways and Means, which is as follows:

[See House Report No. 1595, page 946 this Bulletin]

* * * * * * *

[H. R. 7054—P. L. 417]

CREDIT AGAINST ESTATE TAX FOR TAX ON CERTAIN PRIOR TRANSFERS

[House of Representatives Report No. 1495, Eighty-fourth Congress, First Session]

[July 27, 1955]

Mr. Baker, from the Committee on Ways and Means, submitted the following report [To accompany H. R. 7054]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 7054) to amend the Internal Revenue Code of 1939 to provide a credit against the estate tax for Federal estate taxes paid on certain prior transfers, having considered the same, report favorably thereon with amendments and recommend that the bill, as amended, do pass.

The amendments are as follows:

Page 2, line 1, after "decedent" insert: (but only if the decedent was a citizen or resident of the United States at the time of his death)

Page 2, line 15, strike out "estate tax" and insert "tax imposed by section 935".

Page 5, strike out lines 17 through 21.

Page 5, after line 21, insert: SEC. 2. No interest shall be allowed or paid on any overpayment resulting from the amendment made by the first section of this Act.

PURPOSE OF BILL

This bill adds a new section 814 to the Internal Revenue Code of 1939 providing that an executor of an estate may elect to take a credit against the estate tax for the amount of tax paid on property passing to the decedent from a person who died within 6 months prior to decedent's death. Those who claim such a

credit must forego any deduction for previously taxed property allowed by section 812(c) of the 1939 Code. This new election is to be available with respect to estates of decedents dying after December 31, 1951, and before August 16, 1954.

GENERAL STATEMENT

Section 812(c) of the 1939 Code provided a deduction from the gross estate for the value of property included in the decedent's gross estate which had previously been taxed as part of the estate of an individual who died within 5 years prior to the death of the decedent. The deduction was also available with respect to taxable gifts received by the decedent within 5 years prior to his death. To qualify for the deduction it had to be possible to trace the property in the decedent's estate to the prior decedent or donor. Moreover, no deduction for previously taxed property was allowed if the property was received from a prior decedent who was the decedent's spouse. While section 812(e) allowed a marital deduction for an amount equal to the value of property passing from a decedent to his surviving spouse, this deduction was limited to 50 percent of the value of the adjusted gross estate of the decedent.

Numerous objections were raised to the deduction for previously taxed property under the 1939 code. These include the fact that a deduction for property taxed in a prior estate is an unsatisfactory measure of the tax previously borne by that property, the difficulties faced in attempting to comply with the "tracing" rule, and the inequity in denying any tax relief in the case of property passing to a spouse in excess of amounts for which a marital deduction can be taken. As a result Congress in the Internal Revenue Code of 1954 (section 2013) allowed as a credit against the decedent's tax all, or a portion, of an estate tax previously paid with respect to property transferred to the decedent within 10 years prior to (or 2 years after) his death. Moreover, account was taken of tax previously paid where property was included in the estate of the spouse and where the transfer to the decedent was in excess of the amount for which a marital deduction could be taken.

The credit provided in the 1954 Code only applies, however, in the case of decedents dying after the effective date of the 1954 Code, namely, August 16, 1954. Cases of hardship under the 1939 Code have been called to your committee's attention which deserve the relief provided under the 1954 Code. These are cases where a husband and wife, for example, have died within a short time of each other and where most of the estate of the first decedent passed to the spouse. In such cases, to the extent the property passing to the spouse exceeded the amount which could be taken as a marital deduction, there has been a substantial diminution of estates by the successive levying of death taxes within a brief period of time. Therefore, your committee has made the credit for estate taxes paid on prior transfers available in certain cases under the 1939 Code.

EXPLANATION OF BILL

Subsection (a) of the new section 814 of the 1939 Code provides that executors may elect to claim a credit for the Federal estate tax paid with respect to the transfer of property to the decedent by another person who died within 6 months before the decedent's death. This is to be available only with respect to decedent's dying after December 31, 1951, where the 1939 Code applies. The transfer of property in this case includes property passing as the result of the exercise or nonexercise of a power of appointment. There is no need to provide for reductions in the credit (as under the 1954 Code) where the prior decedent predeceased the decedent by more than 2 years, since the new section 814 of the 1939 Code only applies where the prior decedent died within 6 months before the decedent.

Subsections (b), (c), (d), and (e) of the new section 814 as reported by your committee are the same in substance as the corresponding subsections of section 2013 of the 1954 Code. Subsection (b) deals with the computation of the credit and in general determines the tax paid by the prior decedent which is attributable to property transferred to the decedent. Subsection (c) in general provides that the credit allowed is not to exceed the benefit the decedent would have derived from the omission of the property previously taxed from the base for his estate tax. Subsection (d) relates to the valuation of the property transferred to determine the proportion of the decedent's estate it represents. In general its value is to be its value for purposes of determining the Federal estate tax of the prior decedent reduced by any death tax paid out of this

property, any obligations imposed with respect to the property transferred to the decedent, and any marital deduction claimed by the prior decedent with respect to the property transferred to the decedent. Subsection (e) provides that the term "property" includes a beneficial interest in property, including a general power of appointment.

Subsection (f), which does not correspond to any provision in the 1954 Code, provides that if the executor claims the credit provided by the new section 814 of the 1939 Code he may not take a deduction (under sec. 812 (c)) for property previously taxed. No such deduction is available under the 1954 Code.

This bill has been reported unanimously by your committee.

[H. R. 7054—P. L. 417]

CREDIT AGAINST ESTATE TAX ON CERTAIN PRIOR TRANSFERS

[Senate Report No. 1402, Eighty-fourth Congress, Second Session. Calendar No. 1421]

[January 19 (legislative day, January 16), 1956]

Mr. Byrd, from the Committee on Finance, submitted the following report [To accompany H. R. 7054]:

The Committee on Finance, to whom was referred the bill (H. R. 7054) to amend the Internal Revenue Code of 1939 to provide a credit against the estate tax for Federal estate taxes paid on certain prior transfers, having considered the same, report favorably thereon with amendments and recommended that the bill as amended do pass.

The amendments are as follows:

Page 2, line 8, after " 'transferor')", insert "who was the spouse of the decedent at the time of such person's death and".

Page 2, line 8, strike out "six months" and insert "2 years".

Page 3, line 3, strike out "6 months" and insert "2 years".

PURPOSE OF BILL

This bill adds a new section 814 to the Internal Revenue Code of 1939 providing that an executor of an estate may elect to take a credit against the estate tax for the amount of tax paid on property passing to the decedent from a person who was the spouse of the decedent at the time of such person's death and who died within 2 years prior to decedent's death. Those who claim such a credit must forego any deduction for previously taxed property allowed by section 812 (c) of the 1939 code. This new election is to be available with respect to estates of decedents dying after December 31, 1951, and before August 16, 1954.

GENERAL STATEMENT

Section 812 (c) of the 1939 code provided a deduction from the gross estate for the value of property included in the decedent's gross estate which had previously been taxed as part of the estate of an individual who died within 5 years prior to the death of the decedent. The deduction was also available with respect to taxable gifts received by the decedent within 5 years prior to his death. To qualify for the deduction it had to be possible to trace the property in the decedent's estate to the prior descendent or donor. Moreover, no deduction for previously taxed property was allowed if the property was received from a prior decedent who was the decedent's spouse. While section 812 (e) allowed a marital deduction for an amount equal to the value of property passing from a decedent to his surviving spouse, this deduction was limited to 50 percent of the value of the adjusted gross estate of the decedent.

Numerous objections were raised to the deduction for previously taxed property under the 1939 code. These include the fact that a deduction for property taxed in a prior estate is an unsatisfactory measure of the tax previously borne by that property, the difficulties faced in attempting to comply with the "tracing" rule, and the inequity in denying any tax relief in the case of property passing to a spouse in excess of amounts for which a marital deduction can be taken.

As a result Congress in the Internal Revenue Code of 1954 (section 2013) allowed as a credit against the decedent's tax all, or a portion, of an estate tax previously paid with respect to property transferred to the decedent within 10 years prior to (or 2 years after) his death. Moreover, account was taken of tax previously paid where property was included in the estate of the spouse and where the transfer to the decedent was in excess of the amount for which a marital deduction could be taken.

The credit provided in the 1954 code only applies, however, in the case of decedents dying after the effective date of the 1954 code, namely, August 16, 1954. Cases of hardship under the 1939 code have been called to your committee's attention which deserve the relief provided under the 1954 code. These are cases where a husband and wife, for example, have died within a short time of each other and where most of the estate of the first decedent passed to the spouse. In such cases, to the extent the property passing to the spouse exceeded the amount which could be taken as a marital deduction, there has been a substantial diminution of estates by the successive levying of death taxes within a brief period of time. Therefore, your committee has made the credit for estate taxes paid on prior transfers available in certain cases under the 1939 code.

Your committee has made two amendments to the bill. First, the bill has been extended to cover cases in which the decedent dies within 2 years of the death of the transferor rather than within 6 months as provided in the House bill. This extension of the period to 2 years corresponds with the period for which a full credit is given under section 2039 of the 1954 code. Second, the bill has been restricted to instances in which the transferor of the property was the spouse of the decedent at the time of the transferor's death. Section 812 (c) of the 1939 code denied the deduction to property previously taxed in the case of certain transfers between spouses and this restriction imposed the hardship from which your committee believes relief should be granted.

EXPLANATION OF BILL

Subsection (a) of the new section 814 of the 1939 code provides that executors may elect to claim a credit for the Federal estate tax paid with respect to the transfer of property to the decedent by another person who was the spouse of the decedent at the time of such person's death and who died within 2 years before the decedent's death. This is to be available only with respect to decedents dying after December 31, 1951, where the 1939 code applies. The transfer of property in this case includes property passing as the result of the exercise or nonexercise of a power of appointment. There is no need to provide for reductions in the credit (as under the 1954 code) where the prior decedent predeceased the decedent by more than 2 years, since the new section 814 of the 1939 code only applies where the prior decedent died within 2 years before the decedent.

Subsections (b), (c), (d), and (e) of the new section 814 as reported by your committee are the same in substance as the corresponding subsections of section 2013 of the 1954 code. Subsection (b) deals with the computation of the credit and in general determines the tax paid by the prior decedent which is attributable to property transferred to the decedent. Subsection (c) in general provides that the credit allowed is not to exceed the benefit the decedent would have derived from the omission of the property previously taxed from the base for his estate tax. Subsection (d) relates to the valuation of the property transferred to determine the proportion of the decedent's estate it represents. In general its value is to be its value for purposes of determining the Federal estate tax of the prior decedent reduced by any death tax paid out of this property, any obligations imposed with respect to the property transferred to the decedent, and any marital deduction claimed by the prior decedent with respect to the property transferred to the decedent. Subsection (e) provides that the term "property" includes a beneficial interest in property, including a general power of appointment.

Subsection (f), which does not correspond to any provision in the 1954 code, provides that if the executor claims the credit provided by the new section 814 of the 1939 code he may not take a deduction (under sec. 812 (c)) for property previously taxed. No such deduction is available under the 1954 code.

This bill has been reported unanimously by your committee.

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[H. R. 7094—P. L. 408]

UNLIMITED DEDUCTION FOR CHARITABLE CONTRIBUTIONS

[House of Representatives Report No. 1596, Eighty-fourth Congress, First Session]

[July 29, 1955]

Mr. Cooper, from the Committee on Ways and Means, submitted the following report [To accompany H. R. 7094]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 7094) to amend section 120 of the Internal Revenue Code of 1939 (relating to unlimited deduction for charitable contributions), having considered the same, report favorably thereon with amendments and recommend that the bill, as amended, do pass.

The amendments are as follows:

Page 2, line 13, after "(A)" insert: "an amount equal to".

Page 2, line 15, strike out "a trustee or trustees as described in section 2055 (a)(3)" and insert: "any person or organization described in section 2055".

Page 2, line 17, after "(B)" insert: "an amount equal to".

Page 2, after line 20, insert: No interest shall be paid upon any overpayment resulting from the amendment made by the first section of this Act.

PURPOSE OF BILL

This bill provides that an unlimited charitable deduction is to be available for charitable and other contributions under the 1939 Code where in the current year and in 8 out of 10 of the immediately preceding years the individual's contributions to charity, plus his income-tax payments, accounted for 90 percent or more of his taxable income, but only if an amount equal to any refund under this provision is paid to, or set aside for, charity.

GENERAL STATEMENT

Under the 1939 Code the 20-percent limitation on charitable contributions did not apply where the taxpayer's charitable contributions, plus his income-tax payments, in the current year and in each of the prior 10 years equaled 90 percent or more of his taxable income. Congress in its consideration of the 1954 Code last year decided that this was unduly restrictive, and provided instead that the 90-percent test need be met only in 8 out of 10 of the past years. However, this provision was effective only with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954. The test remained as 10 out of the 10 past years under the 1939 Code.

Just as Congress last year considered the rule of 10 out of the last 10 years to be too restrictive with respect to the future, your committee believes that this rule is unduly restrictive with respect to prior years. For that reason, your committee has extended the 8-out-of-10-year rule to all taxable years to which the 1939 Code applies. However, it is provided that any refund attributable to an overpayment of tax resulting from the enactment of this bill is to be permitted only if the amount of the refund is paid immediately as a charitable contribution. If the taxpayer has died at the time the refund is made, an amount equal to the refund must, under the terms of the decedent's will, be transferred for public, charitable, or religious uses (as described in sec. 2055 of the 1954 Code, which provides a deduction for charitable, etc., contributions for estate-tax purposes), and the amount so transferred must be deductible from the value of the gross estate. It is also provided in the bill that no interest is to be paid with respect to such a refund.

The amount of the refund is not to be taken into account in determining any liability of the taxpayer or his estate for income or estate-tax purposes. Provision is also made for a 7-year statute of limitations in lieu of the ordinary 3-year period of limitation prescribed in section 322(b)(1) of the 1939 Code. The provisions of section 322(b) (2) or (3) of the 1939 Code do not apply to the amount of the overpayment of income tax attributable to the amendment made by the bill.

This bill has been reported unanimously by your committee.

[H. R. 7094—P. L. 408]

AMENDMENT OF SECTION 120 OF THE INTERNAL REVENUE CODE OF 1939 RELATING TO UNLIMITED DEDUCTION FOR CHARITABLE CONTRIBUTIONS

[Senate Report No. 1403, Eighty-fourth Congress, Second Session, Calendar No. 1422]

[January 19 (legislative day, January 16), 1956]

Mr. Byrd, from the Committee on Finance, submitted the following report [To accompany H. R. 7094]:

The Committee on Finance, to whom was referred the bill (H. R. 7094) to amend section 120 of the Internal Revenue Code of 1939 (relating to unlimited deduction for charitable contributions), having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE OF BILL

This bill provides that an unlimited charitable deduction is to be available for charitable and other contributions under the 1939 code where in the current year and in 8 out of 10 of the immediately preceding years the individual's contributions to charity, plus his income-tax payments, accounted for 90 percent or more of his taxable income, but only if an amount equal to any refund under this provision is paid to, or set aside for, charity. This bill entitles a taxpayer who qualifies under its provisions to secure a refund whether his claim is filed before, on, or after the date of enactment of this bill.

GENERAL STATEMENT

Under the 1939 code the 20-percent limitation on charitable contributions did not apply where the taxpayer's charitable contributions, plus his income-tax payments, in the current year and in each of the prior 10 years equaled 90 percent or more of his taxable income. Congress in its consideration of the 1954 code last year decided that this was unduly restrictive, and provided instead that the 90-percent test need be met only in 8 out of 10 of the past years. However, this provision was effective only with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954. The test remained as 10 out of the 10 past years under the 1939 code.

Just as Congress in 1954 considered the rule of 10 out of the last 10 years to be too restrictive with respect to the future, your committee believes that this rule is unduly restrictive with respect to prior years. For that reason, your committee has extended the 8-out-of-10-year rule to all taxable years to which the 1939 code applies. However, it is provided that any refund attributable to an overpayment of tax resulting from the enactment of this bill is to be permitted only if the amount of the refund is paid immediately as a charitable contribution. If the taxpayer has died at the time the refund is made, an amount equal to the refund must, under the terms of the decedent's will, be transferred for public, charitable, or religious uses (as described in sec. 2055 of the 1954 code, which provides a deduction for charitable, etc., contributions for estate-tax purposes), and the amount so transferred must be deductible from the value of the gross estate. It is also provided in the bill that no interest is to be paid with respect to such a refund.

The amount of the refund is not to be taken into account in determining the qualification of the taxpayer for an unlimited charitable deduction for any year or any liability of the taxpayer or his estate for income or estate-tax purposes. Provision is also made for a 7-year statute of limitations in lieu of the ordinary 3-year period of limitation prescribed in section 322(b) (1) of the 1939 code. The provisions of section 322(b) (2) or (3) of the 1939 code do not apply to the amount of the overpayment of income tax attributable to the amendment made by the bill.

This bill has been reported unanimously by your committee.

[H. R. 7201—P. L. 429]

TAXATION OF INSURANCE COMPANY INCOME

[House of Representatives Report No. 1098, Eighty-Fourth Congress, First Session]

[July 11, 1955]

Mr. Mills, from the Committee on Ways and Means, submitted the following report [To accompany H. R. 7201]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 7201) relating to the taxation of income of insurance companies, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

On page 4, beginning in line 11, strike out "this subsection and" and insert "this subsection, subsection (a), and".

PURPOSE

Since 1951 the taxation of life insurance companes has been governed by a stopgap formula first adopted in 1951 and reenacted year by year since. Your committee's bill is intended to replace this stopgap formula as well as the 1942 formula, which will become effective for taxable years beginning after December 31, 1954, unless this bill is enacted or other affirmative steps taken. The Treasury Department estimates that the 1942 formula, should it be effective for the taxable year 1955, would produce $274 million in revenue as contrasted with $189 million for the stopgap formula (that was effective for 1954) and $215 million under the plan proposed by the bill.

BACKGROUND

Until 1921 life insurance companies were taxed in the same manner as ordinary corporations under the general provisions of the revenue laws. However, in recognition of the problems inherent in the nature of life insurance companies they have been taxed since 1921 under special provisions not applicable to other corporations. This special treatment is the product of the following three factors:

(1) Measurement of life insurance income requires assumptions as to future expenses and income. The variety of assumptions used in practice makes it difficult to designate what part of current receipts are truly required to be reserved and what part are surplus.

(2) The annual accounting period, which is applied to business in general, is not a suitable measure of the income from issuing life-insurance contracts, which by their nature may span many decades.

(3) The differences between mutual and stock life insurance companies make it difficult to devise a tax base which does not create competitive inequalities.

In lieu of taxes at the usual corporate rates on total income from whatever source, various formulas for taxing life insurance companies have been devised, and they have been applied equally to stock and mutual companies. The three principal features of these formulas have been:

(1) Only investment income has been subject to tax; underwriting gains and losses (premiums less insurance payments and operating expenses) have not been taxed.

(2) Only a small part of the net investment income has been taxed at regular corporate rates. Until 1951 ordinary corporation taxes were applied to net investment income less a large deduction, computed under various formulas designed to reflect the companies' obligation to credit interest to the insurance reserves and other obligations to pay or credit interest to policyholders. For 1951–54 a tax at 6½ percent of net investment income, more or less equivalent to a full tax on the reduced amount, has been imposed.

(3) Investment income on nonlife insurance business has been taxed at full corporation rates. The amount of this income has been determined as 3¼ percent of the reserves on nonlife insurance (cancelable accident and health, workmen's compensation, etc.).

Since 1948 the life insurance industry has been taxed under "stop-gap" plans enacted from year to year. As a result of this fact and the general need for study in the field, your committee appointed a Subcommittee on the Taxation of Life Insurance Companies in the last Congress to develop a permanent formula for the taxation of life insurance companies.

The subcommittee conducted a series of informal conferences with representatives of the industry, State regulatory groups, and others interested in the field. Following these informal conferences, the subcommittee released in November of 1954 a preliminary statement of facts and issues prepared by the staff of the committee and the staff of the Joint Committee on Internal Revenue Taxation. This preliminary statement became the basis of public hearings, which were held December 14 and 15, 1954.

Early in January of this year the subcommittee issued a report with the following tentative conclusions:

(*a*) That the same tax formula should be applied to both stock and mutual companies with respect to life insurance business.

(*b*) That the discrimination against insured plans compared to tax-free trusts in the employee pension and profit-sharing area be removed.

(*c*) That income from cancelable accident and health insurance business carried on by life insurance companies be taxed separately from income from life insurance business and that it be taxed in the same manner as the income of casualty companies is taxed.

(*d*) That the definition of "investment income" be changed to include royalty income and profits from the temporary operation of a noninsurance business.

(*e*) That corrective steps be taken to eliminate the problems raised by the occasional use of life insurance companies for tax avoidance purposes.

It is believe that this bill to a large degree carries into effect the recommendations and conclusions of the subcommittee on these points.

SUMMARY OF THE BILL

The bill continues to disregard underwriting gains and losses in the determination of taxable income, because of the difficulties of taxing insurance companies on the regular corporate basis. The methods of dealing with investment income and the taxation of income from nonlife insurance business, however, are considerably changed. With respect to investment income related to life insurance reserves, the principle of deducting a fixed percentage of the net investment income is applied to the regular life insurance business. Higher deduction ratios are allowed, however, with respect to two special categories of business: (1) Policies under qualified employee pension plans, and (2) annuities and policyholder deposits. This will mean that the aggregate deduction rate will vary between companies, depending on the types of business done. The special treatment in the employee pension plan area is intended to equalize the tax treatment of life insurance companies in this area with tax-exempt pension trusts. In the area of annuities and deposited funds the special treatment is motivated by the consideration that interest on these earnings is ultimately taxable in the hands of the beneficiaries.

With respect to non-life insurance business, primarily accident and health insurance, the bill moves in the direction of equalizing the tax treatment of life and casualty insurance companies. It is provided that both stock and mutual life insurance companies will pay tax on the income from this business as if it were the income of a mutual casualty insurance company.

The bill makes several changes in the taxation of life insurance income designed to improve the definition of income and to prevent abuse of the life insurance treatment by companies which are not entirely life insurance companies. Several improvements in the income definition have been applied to casualty insurance companies as well as to life insurance companies. The reserve interest credit, a relief device provided in the Revenue Act of 1951 for certain companies with low earnings relative to their reserve and other policy requirements, is retained in substance.

The bill imposes a tax under the new system only for the year 1955 and provides that, if the new system is not extended, a tax similar to that imposed by the Revenue Act of 1942 will come into operation. By this action the committee does not intend any expression of approval of the tax formula provided in the 1942 act, but has provided for the application of that formula to 1956 because it

is the method of taxing life insurance companies under the law as of the present time. The so-called stopgap formula in use since 1950 has not been extended beyond 1954.

The tax formula for 1955 provides only the first step in the transition to the system envisioned by the bill. The 1-year technique is applied to insure that the operation of the new system will be carefully examined at the end of the period, and that the suggestions and recommendations of the Secretary of the Treasury will be carefully considered during that period. On this basis the Secretary of the Treasury has no objection to the enactment of H. R. 7201. However, he suggests that a continuing study be made toward the development of a method of taxing life insurance companies like other business, on the basis of their entire income from all sources. The Treasury Department is impressed with the need for a fair and sound approach to the problem of taxing life insurance companies and is cognizant of the special situation of life insurance companies and their responsibilities to policy holders, but believes that the tax imposed upon such companies should be fairly distributed among companies in the industry, and should be fair in relation to the tax burden of other savings institutions and taxpayers generally.

DETAILED EXPLANATION OF THE BILL

A. Regular Life Insurance Business

The bill provides a deduction of 85 percent of the net investment income allocable to the regular life insurance business. The stopgap tax imposed on life insurance companies from 1951 to 1954 was equivalent to regular corporate rates applied to net investment income after an 87½-percent deduction. On the basis of reserves presently stated on the company books, the industry currently needs less than 85 percent of its net investment income to fulfill policy obligations. This smaller current interest requirement is due in part to the fact that in recent years the companies have transferred considerable amounts of surplus to reserves in a process known as reserve strengthening. While this does reduce the current need for interest additions to reserves, it does not appear desirable that tax liability should depend on pure bookkeeping changes. Moreover, the ratio of interest requirements to current interest earnings will vary considerably over time because of the slow adjustment of reserve interest patterns to changing interest rates. It also does not appear desirable that tax liability should depend on these year-to-year variations in the reserve interest picture.

B. Pension Plan Business

The new system envisaged in the bill provides that, ultimately, insurance companies may deduct from net investment income 100 percent of the earnings on reserves held for policies issued in connection with qualified pension and profit-sharing plans. The policies involved here include group annuities sold directly to an employer and other policies, including life insurance policies which must be converted into annuities, that may be purchased by a qualified pension trust. The investment income related to these policies has been defined so as to correspond as closely as possible to the income that may be accumulated, tax-free, in a qualified trust. Hence, no part of the earnings on capital and surplus have been included. The reserves for these policies are roughly 13 percent of total life insurance assets; however, many companies do not have any of this business.

For 1955 the deduction for this business will be 92.5 percent. If the provisions of this bill are made applicable to subsequent years, this deduction will be 94 percent for 1956 and will reach 100 percent in 1960.

C. Annuities and Policyholder Deposits

The bill provides, for 1955, a deduction of 90 percent of the net investment income earned on assets held as reserves for annuities and for dividend accumulations and insurance proceeds left at interest (including a portion of capital and surplus held for these obligations). This deduction (larger than the deduction for life insurance business) is designed to reflect the fact that this interest is taxable, in general, when received by individuals. In this sense it differs from interest added to life insurance policy reserves, which in general is not taxed as income to individuals. Some tax at the insurance company level

on annuity earnings is justified because the individual tax on the interest is, typically, long postponed. If the new system is made applicable to 1956 and subsequent years this deduction will be 91 percent for 1956 and will increase to 95 percent for 1960.

The bill excludes from the definition of annuities those policies sold on a nonparticipating basis before July 1, 1955. In these cases a tax advantage to the companies would not, as a general rule, result in a benefit to the policyholders.

D. Non-life Insurance Business

The bill provides for 1955 that stock and mutual life insurance companies will pay tax on the income from non-life insurance business as if it were the income of a mutual casualty company. This means that they will pay the higher of (1) a tax at regular corporate rates on their net investment income from that business or (2) a tax of 1 percent on the gross investment income from that business plus premiums (less dividends) on those policies. For this purpose the investment income is required to be determined in the same manner as for a mutual casualty company. This involves taking into account a proportionate part of the net capital gain (to which the alternative capital gains tax is applicable) and a proportionate part of the dividends received credit.

For many years the investment income attributable to the non-life insurance business has been viewed as 3¼ percent of the unearned premiums and unpaid losses on that business. Under this bill the income attributable to the non-life insurance business is that part of the total net investment income which corresponds to the ratio of these non-life reserves to the total reserves.

In the casualty insurance field, where stock companies predominate, the stock companies are subjected to a different tax computation from mutuals, one that usually results in a higher tax. It is feared that if this were applied to the accident and health field of the life insurance industry, where mutuals predominate, the competitive consequences could be quite serious.

E. The Definition of Income

The gross income of a life insurance company under present law is defined as interest, dividends, and rents. This definition has been expanded by including (1) royalties; (2) certain amounts received in connection with entering into, altering, or terminating agreements such as leases and mortgages; and (3) income derived from the operation of a noninsurance business. Royalties are considered to be similar to rents. Similarly, the receipts in connection with certain agreements are considered similar to the income received under the agreements. These amounts would include, for example, a bonus on entering into a lease and a penalty for early repayment of a mortgage. Normally a life insurance company will only have income from a noninsurance business where it acquires a going business in foreclosing a mortgage. Income earned in this situation is considered to be similar to mortgage interest.

The deductions corresponding to these types of income are allowed. Thus, the bill provides a deduction for depletion and a deduction for the ordinary expenses of any noninsurance business. As has always been the case, capital gains are not included in life insurance income.

The deduction for dividends received on corporate stock held for the life insurance business is denied on the grounds that the life insurance company already gets at least an 85 percent deduction on this income.

Where appropriate, these modifications of the definition of investment income have also been applied to casualty insurance companies. For mutual casualty companies there are added to the present definition of income royalties, payments in connection with agreements, and income from a noninsurance business. The corresponding deductions are allowed. Under present law all of these types of income are includible in the case of a stock casualty company, but the bill allows a deduction for depletion which is not allowed in the 1954 Code.

F. Abuses of the Life Insurance Provisions

The bill makes several changes in present law designed to prevent abuses of the special tax treatment permitted in the case of life insurance companies. One of these new provisions is an overall ceiling imposed upon the reserve and other policy liability deduction. That deduction, in general, is determined by means of specified percentages of net investment income and serves in lieu of a deduction

for the actual commitment of each company to pay and accrue interest. But if, on the basis of its actual commitments, the investment income is far greater than what is necessary, instead of deducting the normal percentage, say 85 percent, of this large investment income, a ceiling for the deduction is imposed. The ceiling is roughly 200 percent of the interest requirements on life insurance reserves plus the actual interest commitments on contracts not involving life contingencies, plus dividends to policyholders.

In this computation it is provided that the interest on life insurance reserves to the extent that those reserves are matched by policy loans may be taken at only 100 percent and not 200 percent. This is designed to prevent the abuse of creating more or less fictitious life insurance reserves by selling insurance policies where a policy loan is extended immediately for almost the full amount of the premium.

Another new provision deals with the definition of a life insurance company. Under present law, an insurance company is denominated a life insurance company if more than 50 percent of its reserves are life insurance reserves. This rule is continued, but a modification is provided. Under present law a company finding its reserves other than life (generally accident and health insurance reserves) rising over the 50 percent can avoid taxation as a casualty insurance company by "manufacturing" life insurance reserves through the device of selling insurance policies and extending policy loans to the amount of the reserves set up on these policies. This is a paper transaction to disguise the true character of the company. The bill would remove the amount of policy loans from both life reserves and total reserves and apply the 50 percent test as though these transactions had never occurred.

The inclusion in the bill of a definite formula is not intended to affect the general principles of law under which sham transactions may be disregarded. Furthermore, it should be pointed out that the formula is not confined to situations similar to that described above, since its application is generalized to all policy loans whether or not they arise in the normal course of operations. It is considered that, to the extent a life insurance company lends money to a policyholder, it is creating a position similar to that which would have existed if it had initially sold him a policy involving a lower net reserve.

There is a potential abuse situation in the case of the so-called captive insurance companies. It may be possible for a finance company, for example, to establish a subsidiary life insurance company that will issue life insurance policies in connection with the business of the parent. If the subsidiary charges excessive premium on this business, a portion of the income of the parent company can be diverted to the life insurance company. It is believed that section 482 of the Internal Revenue Code of 1954 (relating to allocation of income and deductions among related taxpayers) provides the Secretary of the Treasury ample regulative authority to deal with this problem.

G. Your Committee's Amendment

The committee amendment set forth at the beginning of this report is intended to make clear the operation of the new section 801(b)(4). Among the items taken into account in determining whether a company meets the definition of a life insurance company for any taxable year are the company's unearned premiums and unpaid losses on certain policies not included in life insurance reserves. This amendment makes it clear that the amount of such unearned premiums and unpaid losses to be taken into account consists of the mean of such amounts at the beginning and end of the taxable year.

SECTION-BY-SECTION ANALYSIS OF THE BILL

First Section

The first section of the bill contains a short title for the bill, namely, the "Life Insurance Company Tax Act of 1955".

Section 2

Section 2 of the bill amends part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 (relating to the taxation of the income of life insurance companies) by substituting for the existing sections 801 to 807, inclusive, a new text which is divided into three subparts:

1. Subpart A (section 801 through 805), which deals with the new formula for the taxation of the income of life insurance companies;
2. Subpart B (sections 811 through 813), which deals with the 1942 formula (with certain revisions) for the taxation of that income, which formula will become effective in 1956 if legislation is not enacted extending the effective period for the new formula set forth in subpart A; and
3. Subpart C (sections 816 and 817), which deals with foreign life insurance companies and the denial of double deductions.

SUBPART A

Section 801. Definition of life insurance companies

The new section 801 embodies, with a few minor changes, the definition of a life insurance company which is contained in section 801 of the Internal Revenue Code of 1954.

Subsections (a), (c), and (e) of section 801 are in substance the same as section 801 of the 1954 Code, while subsection (b), with a minor exception, is in substance the same as section 803(b) of the 1954 Code. Under these subsections the total reserves and the life insurance reserves of an insurance company are defined. The company is treated as a life insurance company if more than 50 percent of its total reserves are life insurance reserves or certain reserves on noncancelable accident and health insurance. Paragraph (4) of subsection (b) specifies that the amount of these reserves shall be the mean of these reserves at the beginning and end of the taxable year. This corresponds to the present practice of the Internal Revenue Service in applying this definitional test.

Subsection (d) of section 801 introduces a new element in the definition of a life insurance company. An insurance company, in computing its life insurance reserves to determine whether it qualifies as a life insurance company under section 801(a), must under the provisions of subsection (d) reduce its life insurance reserves and its total reserves by an amount equal to the mean of the aggregates at the beginning and end of the taxable year, of the policy loans outstanding with respect to contracts for which life insurance reserves are maintained. The term "policy loans" is intended to include loans made by the insurance company, by whatever name called, for which the reserve on a policy is the collateral.

The effect of this subsection may be illustrated by the following example based on hypothetical data for the A insurance company selling only life insurance and cancelable accident and health insurance:

	Jan. 1	Dec. 31	Mean of year
1. Life insurance reserves	1,000	2,000	1,500
2. Policy loans	50	850	450
3. Life reserves less policy loans			1,050
4. Unearned premiums and unpaid losses on cancelable accident and health insurance	900	1,600	1,250
5. Total reserves under the bill (item 3 plus item 4)			2,300
6. Total reserves under present law (item 1 plus item 4)			2,750

The rule provided in the bill requires that the mean of the year figure in item 3 (1,050) be more than 50 percent of the mean of the year figure in item 5 (2,300). Thus under the bill the A company would not qualify as a life insurance company. The present law rule requires that the mean of the year figure in item 1 (1,500) be more than 50 percent of the mean of the year figure in item 6 (2,750). This company would be regarded as a life insurance company under present law.

Section 802. Tax imposed for 1955

The new section 802 imposes the tax on life insurance companies for the year 1955. In the case of a company having no non-life insurance reserves (as defined in sec. 804(g)(2)) the tax provided by subsection (a) applies only on its life insurance taxable income. In the case of a company having non-life insurance reserves the tax is either (1) the tax imposed by section 802(a), or (2) the tax computed under section 802(c)(2), whichever is the higher.

Subsection (a) imposes a tax consisting of a normal tax and a surtax (computed under secs. 11(b) and 11(c) of the 1954 Code, respectively) on the sum of the "life insurance taxable income" plus the "non-life insurance taxable income."

Subsection (b) defines "life insurance taxable income" as the "net investment income" minus the sum of the net investment income allocable to non-life insurance reserves, the reserve and other policy liability deduction, and the special interest deduction (if applicable). The term "net investment income" is explained in section 803; "net investment income, allocable to non-life insurance reserves" in section 804(g); "reserve and other policy liability deduction" in section 804; and "special interest deduction" in section 805.

Subsection (c) provides an alternative method of computing the tax in the case of life insurance companies having non-life insurance reserves. In such cases, the taxpayer insurance company pays the greater of either the tax imposed under section 802(a) or the alternative tax computed under section 802(c)(2). If the operation of section 1201(a) providing an alternative tax on capital gains) reduces the tax computed under section 802(a) to an amount less than that computed under section 802(c)(2), then the latter tax would apply.

The alternative tax under section 802(c)(2) consists of the sum of two partial taxes. The first partial tax is a normal tax and surtax (computed as under secs. 11(b) and 11(c), respectively) on the taxpayer's life insurance taxable income. The second partial tax consists of the sum of (i) 1 percent of that portion of the gross investment income which is allocable to the non-life insurance reserves and (ii) 1 percent of the excess of the net premiums on the non-life insurance contracts over the dividends due policyholders (in their capacity as such) on those contracts. Net premiums and dividends to policyholders are to be computed as provided in section 823. Paragraph (2)(B)(i) of subsection (c) provides that the portion of the gross investment income allocable to non-life insurance reserves is to be an amount which bears the same ratio to gross investment income (reduced by the deduction for wholly exempt interest allowed by section 803(c)(1)) as the non-life reserves bear to the "qualified reserves" (defined under section 804(d)). The "excess" described in clause (ii) of subsection (c) (2) (B) could conceivably be a negative figure which would then reduce the amount to be determined under such subsection.

Subsection (d) of section 802 provides methods for computing the deduction for partially tax-exempt interest. Paragraph (1) of subsection (d) provides (for the purpose of the normal tax computed under section 802(a)) a deduction for partially tax-exempt interest equal to an amount which bears the same ratio to the amount of the deduction provided by section 242 as the sum of the life insurance taxable income (determined under section 802(b)) and the net investment income allocable to non-life insurance reserves (determined under section 804(g) bears to the net investment income. Since the net investment income is reduced by the reserve and other policy liability deduction, the deduction for partially tax-exempt interest is correspondingly reduced. For the purpose of the normal tax in computing the first partial tax under section 802(c)(2)(A), the deduction for partially tax-exempt interest is an amount which bears the same ratio to the amount of the deduction provided by section 242 as the life insurance taxable income bears to the net investment income.

Subsection (e) of section 802 provides for a method of computing the alternative tax on capital gains in the case of a life insurance company which has non-life insurance reserves. Under section 1201(a), if the net long-term capital gain of a corporation exceeds its net short-term capital loss, then the alternative capital gains tax is computed by reference to such excess. Under subsection (e), the excess to be taken into account is an amount which bears the same ratio to the excess described in section 1201(a) as the non-life insurance reserves bear to the qualified reserves. In determining this excess, a net capital loss for any taxable year beginning before January 1, 1955, shall not be taken into consideration.

The "non-life insurance taxable income" of a life insurance company is defined in section 802(f) as the net investment income allocable to non-life insurance reserves increased by a proportionate share of the net capital gain allocable to this non-life insurance income and decreased by the proportionate share of the deductions for dividends received provided in sections 243, 244, and 245.

Section 803. Income and deductions

Section 803 provides rules and definitions for the determination of income and deductions to be used only in the case of life insurance companies.

Subsection (b) of section 803 defines "gross investment income." It starts with the definition of gross income, as provided by section 803(a)(2) of the Internal Revenue Code of 1954, and adds to that definition royalties and gross income from any trade or business (other than an insurance business) carried on by the life insurance company.

Subsection (b)(1) includes in the definition of "gross investment income" the gross amount of any income, received or accrued, during the taxable year, from interest, dividends, rents, and royalties. It is made clear that income includes the gross amount received in conjunction with the making of any lease, mortgage, or other instrument or agreement from which the life insurance company will derive interest, rents, or royalties, and the alteration or termination of any such lease, etc. Examples of such amounts would be a penalty for early payment of a mortgage and a bonus for entering into a lease. Any amount received in conjunction with an agreement which would be deemed a capital gain under other provisions of the Internal Revenue Code will not be included in gross investment income.

Under subsection (b)(2) of section 803, "gross investment income" also includes the gross income from any trade or business (other than an insurance business) carried on by the insurance company individually or in partnership. In determining the amount of income from such trade or business it is provided that any items described in section 803(b)(1) be excluded. Gross investment income does not include any gain from the sale or exchange of a capital asset. This exclusion applies also to any gain which is treated as a gain from the sale or exchange of a capital asset under other provisions of the Internal Revenue Code.

Section 803(c) defines "net investment income" (a term comparable to "taxable income" as used in section 803(g) of the Internal Revenue Code of 1954), as gross investment income (referred to in section 803(b)) less a number of deductions.

The deductions for tax-free interest, investment expenses, and depreciation are in substance the same as provided in section 803(g) of the 1954 Code. As under present law the insurance company is permitted to deduct taxes and other expenses (other than capital improvements) paid or accrued during the taxable year exclusively on or with respect to real estate owned by the company. The bill adds a reference to section 164 to bring into operation here certain changes in the deductibility of taxes adopted in 1954 which are not now applied to insurance companies. Paragraph (5) of section 803(c) provides for a new deduction, that for depletion (and depreciation) allowed by section 611.

Paragraph (6) of this subsection allows the deductions attributable to any trade or business, the income from which is included in the life insurance company's gross investment income by reason of section 803(b)(2), except losses from (*a*) sales or exchanges of capital assets, (*b*) sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and (*c*) losses from the compulsory or involuntary conversion of property used in the trade or business. The allowable deductions may exceed the gross income from this business. Any part of the deductions provided in paragraph (6) will be disallowed to the extent attributable to the carrying on of the insurance business. An example of this disallowance could be provided by a life insurance company that operated a radio station primarily to advertise its own insurance services. A portion of the expenses of the radio station (corresponding to the ratio of the value of advertising furnished to the insurance company to the total value of services rendered by the station) will not be allowed as deductions. Paragraph (6) also excludes the deduction for net operating losses provided in section 172.

Unlike present law this bill omits the deduction for intercorporate dividends in computing the basic net investment income of a life insurance company. It is specified in paragraph (6) that none of the deductions allowed in part VIII of subchapter B shall be allowed as expenses of the noninsurance business.

Subsection (d), limiting the deductions related to real estate, and subsection (e), relating to amortization of premium and accrual of discount on bonds and other evidences of indebtedness are in substance the same as subsections (h) and (i), respectively, of section 803 of the Internal Revenue Code of 1954.

Section 804. Reserve and other policy liability deduction

Section 804 provides a new rule for determining the "reserve and other policy liability deduction" for the purpose of subpart A of part I of subchapter L. Subsections (a) and (b) provide a system of deductions increasing during the

years 1955 to 1960, if subpart A (now applicable only to 1955) is, by subsequent legislative action, applied beyond 1955.

In 1955 the reserve and other policy liability deduction is the sum of the following amounts:

(1) 92.5 percent of the amount of the net investment income allocable to pension plan reserves;

(2) 90 percent of the amount of the net investment income allocable to reserves for annuity contracts and deposits;

(3) 85 percent of the amount by which the net investment income exceeds the sum of the following: the amounts allocable to the reserves described in (1) and (2) above plus the amount of the net investment income allocable to non-life insurance reserves.

Subsection (c) provides that the deduction for reserve and other policy liabilities shall not exceed an amount which is equal to the sum of the following:

(A) Two times the required interest on life insurance reserves (determined under sec. 805(c)(1));

(B) The required interest on reserves for deferred dividends (determined under sec. 805(c)(2));

(C) The amount of interest paid (as defined in section 804(d)); and

(D) The dividends to policyholders paid or declared (other than dividends on non-life insurance contracts referred to in subsection (g)(2)(A) of section 804).

The above sum must be reduced by the amount of the adjustment for policy loans provided in paragraph (2) of subsection (c). For the purposes of (D) the dividends to policyholders shall be construed as those paid, or those declared, according to the method of accounting regularly employed in keeping the books of the insurance company.

Paragraph (2) of subsection (c) provides for the application of an adjustment which will reduce the amount computed under paragraph (1) by an amount equal to the mean of the aggregates (at the beginning and end of the taxable year) of the outstanding policy loans with respect to contracts for which life insurance reserves are maintained, multiplied by the average rate of interest applicable to life insurance reserves.

The application of the preceding subsection may be illustrated by the following example:

The B life insurance company has net investment income of 300, of which 100 is allocable to non-life insurance reserves. The company has some annuity business, and thus the reserve and other policy liability deduction as computed under subsections (a) and (b) of section 804 is 86 percent of 200 or 172. The company must then determine its maximum reserve and other policy liability deduction. The first element of this maximum relates to its interest on life insurance reserves which is computed as follows:

	Reserves Jan. 1	Reserves Dec. 31	Reserves mean of year	Amount of required interest
Reserves at 2½ percent	900	1,100	1,000	25
Reserves at 3 percent	1,050	950	1,000	30
Total			2,000	55

The calculation of the maximum will include twice the sum of 25 and 30 or 110. There is also added interest paid on borrowings and on contracts not involving contingencies, which is 20, and dividends paid to policyholders of 10.

From 140 (the sum of 110, 20, and 10) there must be subtracted the adjustment for loans on policies involving life insurance reserves. The amount of such policy loans is 150 at the beginning of the year and 250 at the end or 200 as the mean. The adjustment for policy loans is determined by first dividing the reserve interest required (55) by the sum of the means of the life insurance reserves (2,000). This average rate is thus 2.75 percent. This rate multiplied by the mean policy loans of 200 yields an adjustment of 5.5. Thus the reserve and other policy liability deduction for the B company will be limited by subsection (c) and will be 140 less 5.5, or 134.5.

Section 804(d) defines the term "qualified reserves" (as used subpart A) as the sum of the following items:

(1) Life insurance reserves (as defined in section 801(b)) plus 7 percent of that portion of such reserves as are computed on a preliminary term basis.

(2) The "non-life insurance reserves" (defined in section 804(g)(2)).

(3) The amounts (discounted at the rates assumed by the company) necessary to satisfy certain obligations under insurance and annuity contracts (including contracts supplementary thereto). Such amounts are to be included only if the above-mentioned obligations, when satisfied, will reflect an increment in the nature of interest, and such obligations do not involve life, health, or accident contingencies at the time with respect to which the computation is made under paragraph (3) of the section 804(d).

(4) The amounts held at the end of the taxable year as reserves for dividends to policyholders, the payment of which dividends is deferred for at least 5 years from the date of the policy contract. Such amount shall not be deemed to include dividends payable during the year following the taxable year for which such computation is made.

(5) The dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts, including supplementary contracts.

(6) Premiums and annuity considerations received in advance, and liabilities for premium deposit funds and for annuity consideration deposit funds.

In applying subsection (a) or (d), the same item shall only be counted once. With the exception of paragraph (4) of section 804(d), the amount of any reserves (or portion thereof) for any taxable year (as used in section 804) shall be the mean of such reserves (or portion thereof) at the beginning and end of the taxable year.

Subsection (e) of section 804 provides for the determination of the net investment income related to the pension plan reserves. Paragraph (1) of subsection (e) provides that the net investment income related to pension plan reserves shall be computed by taking that portion of the net investment income which is proportionate to the ratio of the amount of the pension plan reserves to the mean of the book value of all the assets of the insurance company. The term "book value" is intended to have the same meaning as when used in the annual statement approved by the National Convention of Insurance Commissioners. For this computation, the mean is determined as of the beginning and the end of the taxable year, and in determining all the assets of the insurance company, real property occupied by the insurance company, and furniture, fixtures, and equipment (to the extent such real or personal property is used in carrying on the insurance business) is disregarded.

Paragraph (2) of subsection (e) defines pension plan reserves as that portion of the qualified reserves described in paragraphs (1) and (3) of subsection (d) which is allocable to certain pension plan contracts. Those pension plan contracts are policies (including supplementary contracts) purchased under contracts entered into with trusts which (as of the time the contracts were entered into) were deemed to be either trusts described in section 401(a) and exempt from tax under section 501(a) of the Internal Revenue Code of 1954, or trusts exempt from tax under section 165(a) of the Internal Revenue Code of 1939 as it appeared subsequent to the 1942 amendments or section 165 of such code as it appeared prior to the 1942 amendments, or the corresponding provisions of prior revenue laws. Also included are contracts entered into under qualified insured plans which, as of the time the contracts were entered into, were deemed to be plans meeting the requirements of section 401(a) (3), (4), (5), and (6) of the Internal Revenue Code of 1954, or the requirements of section 165(a) (3), (4), (5), and (6) of the Internal Revenue Code of 1939 (which were added in 1942). Pension plan contracts also include those provided for employees of the life insurance company under a plan which for the taxable year of the life insurance company meets the requirements of section 401(a) (3), (4), (5), and (6).

Paragraph (2) provides, in effect, that if at the time of the purchase of a contract from an insurance company, a trust or pension plan is qualified under the appropriate one of the above-mentioned provisions of the internal revenue laws, the reserves relating to such contracts can be included as pension plan reserves. This requires that the particular insurance policy purchased be a type of policy that could be purchased under the plan without loss of its qualified status. Thus the contract could be a life insurance contract if under the terms of the plan the policy must be converted to an annuity at the time of the employee's retirement. These reserves may be included despite the fact that the plan or trust might at a later date be retroactively disqualified to a time prior to the time of purchase

of the contracts from the insurance company. The insurance company, therefore, need only be concerned with the qualification of the trust or pension plan at the time the trust or employer entered into a contract with the insurance company.

Subsection (f) of section 804 defines net investment income allocable to reserves for annuity contracts and deposits. Paragraph (1) of subsection (f) provides that the amount of net investment income allocable to reserves for annuity contracts and deposits is that amount which bears the same ratio to the net investment income as such reserves bear to the qualified reserves as defined in section 804(d).

Paragraph (2)(A) of subsection (f) defines reserves for annuity contracts and deposits as the sum of the following:

(*a*) That portion of the qualified reserves described in paragraphs (1) and (3) of subsection (d) which is allocable to annuity contracts, including annuities certain; and

(*b*) The amounts described in subsection (d)(5) of section 804 (dividend accumulations and other amounts held at interest in connection with insurance or annuity contracts, etc.).

Clause (iii) of paragraph (2)(B) excludes from the definition of reserves for annuity contracts and deposits any item which is allocable to a contract entered into before July 1, 1955, or to a contract the terms of which are dependent on terms of a contract entered into before July 1, 1955. This clause shall not apply if (as of July 1, 1955) such contract (or predecessor in effect on such date) provided for participation in surplus earnings of the company. A contract shall be considered to be dependent on terms of a prior contract if it is issued under an option in the prior contract or if it constitutes only a modification of the earlier contract. Pension plan reserves are excluded from the definition of annuity reserves.

Paragraph (3) of subsection (f) defines the term "annuity contracts." Such definition is intended to exclude from this calculation any annuity contract which provides a death benefit which is more than a refund of the consideration plus interest.

It is provided that an annuity is a contract providing installment payments to one or more annuitants arising under a life insurance, annuity, endowment, or supplementary contract. Subparagraph (C) requires that if such installment payments arise under a life insurance, endowment, or supplementary contract they will only be regarded as annuities when installment payments have become payable. Thus a contract providing a deferred annuity with no option for life insurance benefits could be considered an annuity contract from the beginning. A life insurance contract providing an annuity to the beneficiary of the insured or providing an annuity option to the insured or his beneficiary will not be regarded as an annuity until installment payments become due.

Subparagraph (B) provides a limitation on death benefits which may be payable under a contract providing installment payments without disqualifying it as an annuity contract. The test goes to the earliest time (following the time at which the reserve is computed) when an amount may be paid under the contract other than as a dividend or an installment to the annuitant entitled to the next installment payment. Such payments would be ordinarily refunds or installments following the death of such an annuitant. The amount of such death benefits may not exceed the consideration paid for the contract plus accrued interest up to the payment date less amounts previously received under the contract. In the case of an annuity, or installment payments, elected as an option on life insurance benefits, the proceeds at the death of the insured is regarded as the amount otherwise invested in the agreement.

Subsection (g) of section 804 provides for the definition of non-life insurance reserves and for the method of determining the amount of the net investment income allocable to such reserves.

Paragraph (1) of subsection (g) provides for the determination of the net investment income allocable to non-life insurance reserves as that amount which bears the same ratio to the net investment income as such reserves bear to the qualified reserves. Paragraph (2) of the subsection defines non-life insurance reserves as the sum of the unearned premiums and the unpaid losses (whether or not ascertained) on contracts other than life insurance, annuity, and noncancelable health and accident insurance contracts, except any unearned premiums and unpaid losses which are included in the life insurance reserves as defined in section 801(b). The parenthetical phrase "whether or not ascertained" is intended as continuation of the treatment accorded unpaid losses under present

law. The unearned premiums shall not be considered to be less than 25 percent of the net premiums written during the taxable year on such contracts.

Paragraph (3) of subsection (g) provides for an adjustment (under regulations prescribed by the Secretary or his delegate) with respect to certain non-life insurance contracts that do have some life insurance reserves.

Section 805. Special interest deduction

Section 805 provides for a special interest deduction (comparable to the reserve interest credit provided in section 805(b) of the Internal Revenue Code of 1954) to be used when computing the tax imposed by section 802. The deduction is provided for life insurance companies whose net investment incomes are insufficient or barely sufficient to meet their required interest commitments.

The deduction is determined as under present law, with some minor changes. Under present law if the ratio of adjusted taxable income to required interest is less than 1.00 the company receives an additional deduction of 50 percent of the income subject to the life insurance tax. To conform the numerator of this ratio to the current bill an adjusted net investment income is used described in subsection (b). To retain the effect of the provision under present law the ratio is multiplied by the net investment income reduced by the sum of net investment income allocable to non-life insurance reserves and the reserve and other policy liability deduction. As under present law reduced allowances are made where the ratio is between 1.000 and 1.05.

A minor change in the definition of required interest is made. Under present law the required interest with respect to the reserve for deferred dividends is deemed to be 2 percent. Under the bill the actual interest rate is used.

SUBPART B.—1942 FORMULA

Sections 811, 812, and 813 provide that after 1955, if the subpart A tax is not extended, certain provisions of the Revenue Act of 1942 are to be combined with certain of the new provisions set forth in subpart A. The particular 1942 provisions that would come back into operation would be the method of determining the reserve and other policy liability deduction by reference to the Secretary's ration (section 812) and the computation of income on non-life insurance business by means of applying 3¼ percent to certain reserves (section 813).

The features of subpart A which are made permanent are:

(1) The new definitions relating to investment income;

(2) Denial of the dividends received credit;

(3) The maximum limit on the reserve and other policy liability deduction;

(4) The adjustment for policy loans in the 50 percent test used to define a life insurance company; and

(5) The special interest deduction.

Section 811. Tax imposed

Subsections (a) and (b) of section 811 are in substance the same as section 802(a) of the Internal Revenue Code of 1954, except that the special interest deduction is allowed.

Subsection (c) of section 811 provides an adjustment in computing the special interest deduction. Under this subjection, the computations under the specified provisions of the new section 805 will be made by substituting the amount of the adjustment for certain reserves provided in section 813 for the net investment income allocable to non-life insurance reserves. For purposes of section 805(b), the substitution will be made after the net investment income has been computed within the reduction for wholly exempt interest. Thus, in applying section 805(b)(2) with respect to subpart B, the amount taken into account will be 50 percent of the amount of the adjustment for certain reserves, in lieu of 50 percent of the net investment income allocable to non-life insurance reserves.

Section 812. Reserve and other policy liability deduction

Section 812 is in substance the same as section 804(a) of the Internal Revenue Code of 1954. The term "net investment income" is substituted for the term "taxable income" wherever such term is used in section 804 of the 1954 Code.

Subsection (b) contains definitions corresponding to the definitions found in subsections (c), (d), (e), and (f) of section 803 of the 1954 Code.

Subsection (c) applies the same maximum limit to the reserve and other policy liability deduction allowed by section 812(a) as the maximum limit applied by section 804(c).

Section 813. Adjustment for certain reserves

Section 813, in substance the same as section 806 of the Internal Revenue Code of 1954, provides for an adjustment for certain reserves in the case of a life insurance company writing contracts other than life insurance, annuity, and noncancelable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancelable health and accident insurance).

SUBPART C.—MISCELLANEOUS PROVISIONS

Section 816. Foreign life insurance companies.

Section 816 is in substance the same as section 807 of the Internal Revenue Code of 1954.

Section 817. Denial of double deductions

Section 817 applies to part I the prohibition against double deductions found in section 803 (j) of the Internal Revenue Code of 1954.

SECTION 3. ADJUSTMENT TO INVESTMENT INCOME OF INSURANCE COMPANIES OTHER THAN LIFE

Subsection (a) of section 3 contains amendments to part II of subchapter L of chapter 1 of the Internal Revenue Code of 1954 (relating to mutual insurance companies other than life). These amendments conform the investment income which is used as a tax base in the case of these mutual insurance companies to the revised concept of investment income which will apply to life insurance companies under the new part I. The principal changes are the inclusion of royalties, and the income from a trade or business other than the insurance business together with the deductions attributable thereto. No change is made in the availability of the deduction for dividends received.

Subsection (b) of section 3 contains amendments to part III of subchapter L (relating to stock insurance companies other than life). Since these companies are, in effect, taxed on the regular corporate basis, no change was necessary in the definition of their investment income. However, technical amendments were made to permit them to take a deduction for depletion (which was not specifically allowed by the Internal Revenue Code of 1954), to correct the special capital loss deduction provisions, and to correct a cross reference to the definition of life insurance reserves.

SECTION 4. ANNUAL ACCOUNTING PERIOD OF INSURANCE COMPANIES TO BE A CALENDAR YEAR

This section adds section 843 to part IV of subchapter L of chapter 1 of the Internal Revenue Code of 1954. Section 843 provides that for the purposes of subtitle A of the Internal Revenue Code of 1954 the annual accounting period for each insurance company subject to a tax imposed by subchapter L shall be the calendar year.

SECTION 5. TECHNICAL AMENDMENTS

This section makes certain technical amendments to provisions of the Internal Revenue Code of 1954 outside of the first three parts of subchapter L to conform those provisions to the changes in subchapter L made by sections 2 and 3 of the bill.

Paragraph (2) of this section amends paragraph (16) of section 501 (c) of the Internal Revenue Code, which provides an exemption from tax for certain small mutual insurance companies and associations. Under present law, such a company or association is exempt if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000. Under the amendment, the broader concept of the gross investment income contained in the bill is substituted for interest, dividends, and rents.

SECTION 6. EFFECTIVE DATE

Section 6 provides that the amendments made by the bill shall apply only to taxable years beginning after December 31, 1954.

[H. R. 7201—P. L. 429]

TAXATION OF INSURANCE COMPANY INCOME

[Senate Report No. 1571, Eighty-fourth Congress, Second Session. Calendar No. 2596]

[February 23 (legislative day, February 22), 1956]

Mr. Byrd, from the Committee on Finance, submitted the following report [To accompany H. R. 7201]:

The Committe on Finance, to whom was referred the bill (H. R. 7201) relating to the taxation of income of insurance companies, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

(1) The House bill rewrites section 804 of the Internal Revenue Code of 1954 which provides a reserve and other policy liability deduction against the investment income of a life insurance company. Under the House bill for 1955 this deduction would be determined as 92½ percent of the net investment income allocable to pension plan reserves plus 90 percent of such income allocable to reserves for annuity contracts and deposits plus 85 percent of so much of the balance of the investment income as is not allocable to non-life-insurance reserves. Your committee has amended this provision to delete all special deductions with reference to pension, annuity, and deposit business, and to provide a larger deduction primarily affecting certain small life insurance companies. Under your committee's bill the deduction will be 87½ percent of the first $1 million of net investment income allocable to life insurance reserves and 85 percent of the balance allocable to such reserves.

(2) Under section 804, as provided in the House bill, a maximum limitation is imposed upon the reserve and other policy liability deduction of a life insurance company. In general, this limitation is equal to two times the reserve interest requirements shown on the company's own books on reserves in connection with policies involving life contingencies, plus the amount of certain other interest obligations and dividends to policyholders. Your committee has amended this provision to allow a statutory presumption of reserve interest in the case of certain mutual assessment life insurance companies which do not have a formal reserve interest obligation.

(3) The House bill would add a new section 818 to the Internal Revenue Code which allows an alternative tax base related to total income for the first 5 years of operation in the case of a life insurance company first authorized to do life insurance business before July 1, 1955. Your committee has amended this provision to make it applicable to the first 5 years of operation of a company whenever organized.

(4) Life insurance companies were in doubt about the applicable tax law at the time when the estimated tax for 1955 was payable, September 15 and December 15 of 1955. Under general authority provided by the Internal Revenue Code, the Commissioner of Internal Revenue extended the time for filing the declaration of estimated tax for these corporations until March 15, 1956. However, these companies were not released from the additions to tax provided under section 6655 of the Internal Revenue Code for failure to pay the estimated tax. Your committee has added a section 7 to the House bill to provide that no additions to tax shall be made in this situation.

(5) Several clarifying amendments have been made in the House bill. These amendments are discussed below.

PURPOSE OF THE BILL

This bill, as amended by your committee, has two principal purposes. Basically the bill provides a tax on life insurance companies for the year 1955. To this extent it is a stopgap bill. Under the terms of the bill for 1956 and later years, the tax formula provided under present law for life insurance companies will be in operation. This is, basically, the same formula that was first enacted in the Revenue Act of 1942. The committee expects that additional legislation will be initiated in the House during this year relating to the taxing of life insurance companies for the future. In this connection the Secretary of the Treasury has stated:

"* * * I suggest that an attempt be made to develop a method of taxing life insurance companies like other business, on the basis of their entire income from all sources, with appropriate deductions for their expenses and additions to their reserves against policy contracts * * *. It should now be possible to develop a fairer basis for taxation which will include all of the income and deduction items which properly reflect the earnings position of a life insurance company."

Apart from the 1-year provisions of this bill, certain basic reforms are made in the detailed procedures for taxing life insurance companies that may be applicable in the future under any investment income formula. Under the House bill, as with the bill as amended by your committee, these reforms are incorporated in the basic (1942) provisions so they will become operative in 1956 if those provisions become effective after 1955.

SUMMARY OF THE BILL

The bill continues to disregard underwriting gains and losses in the determination of taxable income, because of the difficulties of taxing insurance companies on the regular corporate basis. The methods of dealing with investment income and the taxation of income from non-life insurance business, however, are somewhat changed. The formula in effect in 1954 in effect taxed life insurance companies at regular corporate rates after deducting 87½ percent of the portion deemed allocable to life insurance business. This deduction ratio is retained for the first $1 million of such income and a deduction ratio of 85 percent is provided for the balance.

With respect to non-life-insurance business, primarily accident and health insurance, the bill moves in the direction of equalizing the tax treatment of life and casualty insurance companies. It is provided that both stock and mutual life insurance companies will pay tax on the income from this business as if it were the income of a mutual casualty insurance company.

The bill makes several changes in the taxation of life insurance income designed to improve the definition of income and to prevent abuse of the life insurance treatment by companies which are not entirely life insurance companies. Several improvements in the income definition have been applied to casualty insurance companies as well as to life insurance companies. The reserve interest credit, a relief device provided in the Revenue Act of 1951 for certain companies with low earnings relative to their reserve and other policy requirements, is retained in substance.

The bill imposes a tax under the new system only for the year 1955 and provides that a tax similar to that imposed by the Revenue Act of 1942 will come into operation thereafter. By this action the committee does not intend any expression of approval of the tax formula provided in the 1942 act, but has provided for the application of that formula to 1956 because it is the method of taxing life insurance companies under the law as of the present time. The so-called stopgap formula in use since 1950 has not been extended beyond 1954.

It is estimated that the tax imposed on life insurance companies for the calendar year 1955, under this bill, will be $248 million. This differs from the tax that would be imposed by the House bill, which was $220 million. If the life insurance companies had continued to pay tax under the formula in effect in 1954, the tax on 1955 income would have been $197 million.

Discussion of Substantive Committee Amendments

The principal amendment made by your committee removes from the House bill the provisions for special treatment of the business of a life insurance company connected with qualified pension plans and with annuities and deposits. Various companies objected to these provisions in the House bill. Your committee thought that it could not enact into law the principle of special treatment of pension and annuity business without hearings and further study. Since time did not permit such a study, the provisions have been removed from this bill with the understanding that this question will be further examined by the Congress in connection with legislation for 1956.

The special treatment of the first $1 million of investment income in the hands of a life insurance company is designed to provide that relatively small life insurance companies would pay approximately the same tax as they would have paid under the law in effect in 1954.

It was felt that a tax increase on these companies might hinder the growth of competition in this field. The small business relief has been designed in such

a manner that it will relate only to the life insurance portion of the company's income and will not involve a notch area subject to a high marginal rate of tax.

The extension of the application of section 818 of the House bill is designed to deal with the problem with respect to certain new life insurance companies which was created by a loophole closing provision inserted in the House bill. Under present law an insurance company may be able to have a relatively large life insurance deduction, proportionate to a relatively large investment income, even though its life insurance obligations may require only a small amount of investment income. In the extreme this might permit a company to be operated primarily as an investment company with very little life insurance business. H. R. 7201 deals with this problem by limiting the deduction against investment income to twice the amount actually needed according to the company's books for reserve interest requirements plus the amount needed for other interest commitments and policy dividends. Thus, excess investment income would be taxed at full corporate rates. Any new company must, however, have an initial capital before it can sell any insurance and have reserves. Thus, for a while it is bound to have excess investment income. The House bill provided relief in this situation for a new company first authorized to do business before the approximate announcement date of the House bill. Such company would be permitted to use as an alternative tax base its total income before tax as reported on the annual statement to the National Convention of Insurance Commissioners. This relief device would permit the company to take into account any excess of its insurance expenses over its premiums. It would automatically relieve a new, expanding life insurance company because excess investment income would be taxable only to the extent that it was not used to cover deficits incurred in establishing the life insurance business. Your committee approves of the intention of this provision and has extended it to new companies whenever authorized to commence business.

The maximum limitation of the reserve and other policy liability deduction provided in the House bill would work an unintended hardship in the case of certain mutual assessment life insurance companies which must keep a deposit with State insurance departments. These companies have reserves recognized as life insurance reserves under present law and they earn interest, but the policy contract does not specify a required interest on such reserves. Under the House bill, therefore, the entire interest earned would be deemed to be excess interest. Your committee has amended the House bill to allow a statutory presumption of required interest up to 3 percent in this case. This will put such companies in substantially the same position as other mutual insurance companies.

The bill was received from the House by your committee in July of 1955. At the same time certain other pressing legislation was received. Your committee did not feel able to give adequate consideration to the problems involved in the short time before adjournment. This left life insurance companies apparently subject to tax on 1955 income under the terms of the 1942 formula, which would involve a higher tax than was imposed under the House bill. Since your committee did not intend that this formula should come into operation, the Commissioner of Internal Revenue used the general authority provided under the Internal Revenue Code to postpone for life insurance companies the time for filing the declaration of estimated tax. This declaration was required under the Internal Revenue Code of 1954, which provided that in 1955 corporations (with probable tax liabilities over $100,000) would be required to estimate the tax payable on the income of that year, and pay 5 percent of such estimate by September 15 and 5 percent by December 15. While the Commissioner postponed the date for filing the declaration the companies involved were not relieved of the obligation for additions to tax for failure to pay appropriate amounts on September 15 and December 15. This addition to tax is computed at the rate of 6 percent per annum on the underpayment. It was indicated at that time that it was the intention of your committee to propose that these companies be relieved of the addition to tax, which the amendment adding section 7 to the bill does.

Discussion of Clarifying Committee Amendments

Several clarifying amendments have been made in the House bill. The first of these corrects an erroneous reference contained in the last sentence of section 802(f). The second of these amendments is made to the last sentence of paragraph (2) of section 804(b). This amendment makes it clear that in computing the average rate of interest for purposes of the adjustment for policy loans, there shall be taken into account 7 percent of that portion of the life insurance

reserves which are computed on a preliminary term basis. The third of these clarifying amendments is made to subsection (c) of section 811. This subsection provides the manner for computing the special interest deduction under the 1942 life insurance formula which the bill provides shall come into effect in 1956. The amendment is designed to make the special interest deduction operate in the same manner as it did from 1951 to 1954. The last of the clarifying amendments changes section 818 of the House bill. Subsection (c) of this section provides that a certain part of the dividends received credit shall be allowed in the case of new companies taxed on the basis of total income. The amendment is designed to insure that the deduction will in fact be allowed.

DETAILED EXPLANATION OF THE BILL

A. Regular Life Insurance Business

Except for special treatment of the first $1 million, the bill provides a deduction of 85 percent of the net investment income allocable to the regular life insurance business. On the basis of reserves presently stated on the company books, the industry currently needs less than 85 percent of its net investment income to fulfill policy obligations, although the committee was told that 85 percent is an average deduction ratio over the last 5 years. This smaller current interest requirement is due in part to the fact that in recent years the companies have transferred considerable amounts of surplus to reserves in a process known as reserve strengthening. While this does reduce the current need for interest additions to reserves, it does not appear desirable that tax liability should depend on pure bookkeeping changes. Moreover, the ratio of interest requirements to current interest earnings will vary considerably over time because of the slow adjustment of reserve interest patterns to changing interest rates. It also does not appear desirable that tax liability should depend on these year-to-year variations in the reserve interest picture.

B. Nonlife Insurance Business

The bill provides for 1955 that stock and mutual life insurance companies will pay tax on the income from nonlife insurance business as if it were the income of a mutual casualty company. This means that they will pay the higher of (1) a tax at regular corporate rates on their net investment income from that business or (2) a tax of 1 percent on the gross investment income from that business plus premiums (less dividends) on those policies. For this purpose the investment income is required to be determined in the same manner as for a mutual casualty company. This involves taking into account a proportionate part of the net capital gain (to which the alternative capital gains tax is applicable) and a proportionate part of the dividends received credit.

For many years the investment income attributable to the nonlife insurance business has been viewed as 3¼ percent of the unearned premiums and unpaid losses on that business. Under this bill for 1955 the income attributable to the nonlife insurance business is that part of the total net investment income which correrspponds to the ratio of these nonlife reserves to the total reserves.

In the casualty insurance field, where stock companies predominate, the stock companies are subjected to a different tax computation from mutuals, one that usually results in a higher tax. It is feared that if this were applied to the accident and health field of the life insurance industry, where mutuals predominate, the competitive consequences could be quite serious.

C. The Definition of Income

The gross income of a life insurance company under present law is defined as interest, dividends, and rents. This definition has been changed by expressly including (1) royalties; (2) certain amounts received in connection with entering into, altering, or terminating agreements such as leases and mortgages; and (3) income derived from the operation of a noninsurance business. Royalties are considered to be similar to rents. Similarly, the receipts in connection with certain agreements are considered similar to the income received under the agreements. These amounts would include, for example, a bonus on entering into a lease and a penalty for early repayment of a mortgage. Normally a life insurance company will only have income from a noninsurance business where it acquires

a going business in foreclosing a mortgage. Income earned in this situation is considered to be similar to mortgage interest. In some cases there is uncertainty as to the status of these items under present law.

The deductions corresponding to these types of income are allowed. Thus, the bill provides a deduction for depletion and a deduction for the ordinary expenses of any noninsurance business. As has always been the case, capital gains are not included in life insurance income.

The deduction for dividends received on corporate stock held for the life insurance business is denied on the grounds that the life insurance company already gets at least an 85 percent deduction on this income.

Where appropriate, these modifications of the definition of investment income have also been applied to casualty insurance companies. For mutual casualty companies there are expressly added to the present definition of income royalties, payments in connection with agreements, and income from a noninsurance business. The corresponding deductions are allowed. Under present law all of these types of income are includible in the case of a stock casualty company, but the bill allows a deduction for depletion which is not allowed in the 1954 Code.

D. Abuses of the Life Insurance Provisions

The bill makes several changes in present law designed to prevent abuses of the special tax treatment permitted in the case of life insurance companies. One of these new provisions is an overall ceiling imposed upon the reserve and other policy liability deduction. That deduction, in general, is determined by means of specified percentages of net investment income and serves in lieu of a deduction for the actual commitment of each company to pay and accrue interest. But if, on the basis of its actual commitments, the investment income is far greater than what is necessary, instead of deducting the normal percentage, 87½ or 85 percent, of this large investment income, a ceiling for the deduction is imposed. The ceiling is roughly 200 percent of the interest requirements on life insurance reserves plus the actual interest commitments on contracts not involving life contingencies, plus dividends to policyholders. A dividends received deduction is allowed for the portion of dividends included in the part of income taxable at full rates. In some cases there is uncertainty as to the status of these items under present law.

In the computation of the ceiling on the reserve and other policy liability deduction it is provided that the interest on life insurance reserves to the extent that those reserves are matched by policy loans may be taken at only 100 percent and not 200 percent. This is designed to prevent the abuse of creating more or less fictitious life insurance reserves by selling insurance policies where a policy loan is extended immediately for almost the full amount of the premium.

Another new provision deals with the definition of a life insurance company. Under present law, an insurance company is denominated a life insurance company if more than 50 percent of its reserves are life insurance reserves. This rule is continued, but a modification is provided. Under present law a company finding its reserves other than life (generally accident and health insurance reserves) rising over the 50 percent can avoid taxation as a casualty insurance company by "manufacturing" life insurance reserves through the device of selling insurance policies and extending policy loans to the amount of the reserves set up on these policies. This is a paper transaction to disguise the true character of the company. The bill would remove the amount of policy loans from both life reserves and total reserves and apply the 50 percent test as though these transactions had never occurred.

The inclusion in the bill of a definite formula is not intended to affect the general principles of law under which sham transactions may be disregarded. Furthermore, it should be pointed out that the formula is not confined to situations similar to that described above, since its application is generalized to all policy loans whether or not they arise in the normal course of operations. It is considered that to the extent a life insurance company lends money to a policyholder it is creating a position similar to that which would have existed if it had initially sold him a policy involving a lower net reserve.

There is a potential abuse situation in the case of the so-called captive insurance companies. It may be possible for a finance company, for example, to establish a subsidiary life insurance company that will issue life insurance policies in connection with the business of the parent. If the subsidiary charges excessive premium on this business, a portion of the income of the parent company can be

diverted to the life insurance company. It is believed that section 482 of the Internal Revenue Code of 1954 (relating to allocation of income and deductions among related taxpayers) provides the Secretary of the Treasury ample regulative authority to deal with this problem.

E. New Insurance Companies

An alternative tax base is provided for the first 5 years during which a company is authorized to do business as an insurance company. Basically this section provides that if the investment income exceeds two times the interest requirements, so that the ceiling on the reserve and other policy liability deduction would come into effect then the tax base cannot exceed the net gain from operations, after dividends to policyholders but before Federal income tax, as shown by the annual statement approved by the National Convention of Insurance Commissioners. In no case can this provision make the tax less than it would have been if there was no ceiling on the reserve and other policy liability deduction. Thus the company will be taxable at least on 12½ percent of its first $1 million of investment income on life insurance business and on 15 percent of the balance.

SECTION-BY-SECTION ANALYSIS OF THE BILL

First Section

The first section of the bill contains a short title for the bill, namely, the "Life Insurance Tax Act for 1955".

Section 2

Section 2 of the bill amends part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 (relating to the taxation of the income of life insurance companies) by substituting for the existing sections 801 to 807, inclusive, a new text which is divided into three subparts:

1. Subpart A (sections 801 through 805), which deals with the new formula for the taxation of the income of life insurance companies for the taxable year 1955;
2. Subpart B (sections 811 through 813) which deals wiht the 1942 formula (with certain revisions) for the taxation of that income, which formula will become effective in 1956 if other legislation is not enacted; and
3. Subpart C (sections 816, 817, and 818), which deals with foreign life insurance companies, the denial of double deductions, and an alternate treatment for certain new life insurance companies.

SUBPART A

Section 801. Definition of life insurance companies

The new section 801 embodies, with a few minor changes, the definition of a life insurance company which is contained in section 801 of the Internal Revenue Code of 1954.

Subsections (a), (c), and (e) of section 801 are in substance the same as section 801 of the 1954 code, while subsection (b), with a minor exception, is in substance the same as section 803(b) of the 1954 code. Under these subsections the total reserves and the life insurance reserves of an insurance company are defined. The company is treated as a life insurance company if more than 50 percent of its total reserves are life insurance reserves or certain reserves on noncancelable accident and health insurance. Paragraph (4) of subsection (b) specifies that the amount of these reserves shall be the mean of these reserves at the beginning and end of the taxable year. This corresponds to the present practice of the Internal Revenue Service in applying this definitional test.

Subsection (d) of section 801 introduces a new element in the definition of a life insurance company. An insurance company, in computing its life insurance reserves to determine whether it qualifies as a life insurance company under section 801(a), must under the provisions of subsection (d) reduce its life insurance reserves and its total reserves by an amount equal to the mean of the aggregates, at the beginning and end of the taxable year, of the policy loans outstanding with respect to contracts for which life insurance reserves are maintained. The term "policy loans" is intended to include loans made by the insurance company, by whatever name called, for which the reserve on a policy is the collateral.

The effect of this subsection may be illustrated by the following example based on hypothetical data for the A insurance company selling only life insurance and cancelable accident and health insurance:

	Jan. 1	Dec. 31	Mean of year
1. Life insurance reserves	1,000	2,000	1,500
2. Policy loans	50	850	450
3. Life reserves less policy loans			1,050
4. Unearned premiums and unpaid losses on cancelable accident and health insurance	900	1,600	1,250
5. Total reserves under the bill (item 3 plus item 4)			2,300
6. Total reserves under present law (item 1 plus item 4)			2,750

The rule provided in the bill requires that the mean of the year figure in item 3 (1,050) be more than 50 percent of the mean of the year figure in item 5 (2,300). Thus under the bill the A company would not qualify as a life insurance company. The present law rule requires that the mean of the year figure in item 1 (1,500) be more than 50 percent of the mean of the year figure in item 6 (2,750). This company would be regarded as a life insurance company under present law.

Section 802. Tax imposed for 1955

The new section 802 imposes the tax on life insurance companies for the year 1955. In the case of a company having no non-life insurance reserves (as defined in sec. 804(d)(2)) the tax provided by subsection (a) applies only on its life insurance taxable income. In the case of a company having non-life insurance reserves the tax is either (1) the tax imposed by section 802(a), or (2) the tax computed under section 802(c)(2), whichever is the higher.

Subsection (a) imposes a tax consisting of a normal tax and a surtax (computed under secs. 11(b) and 11(c) of the 1954 Code, respectively) on the sum of the "life insurance taxable income" plus the "non-life insurance taxable income."

Subsection (b) defines "life insurance taxable income" as the "net investment income" minus the sum of the net investment income allocable to non-life insurance reserves, the reserve and other policy liability deduction, and the special interest deduction (if applicable). The term "net investment income" is explained in section 803; "net investment income allocable to non-life insurance reserves" in section 804(d); "reserve and other policy liability deduction" in section 804; and "special interest deduction" in section 805.

Subsection (c) provides an alternative method of computing the tax in the case of life insurance companies having non-life insurance reserves. In such cases, the taxpayer insurance company pays the greater of either the tax imposed under section 802(a) or the alternative tax computed under section 802(c)(2). If the operation of section 1201(a) (providing an alternative tax on capital gains) reduces the tax computed under section 802(a) to an amount less than that computed under section 802(c)(2), then the latter tax would apply.

The alternative tax under section 802(c)(2) consists of the sum of two partial taxes. The first partial tax is a normal tax and surtax (computed as under secs. 11(b) and 11(c), respectively) on the taxpayer's life insurance taxable income. The second partial tax consists of the sum of (i) 1 percent of that portion of the gross investment income which is allocable to the non-life insurance reserves and (ii) 1 percent of the excess of the net premiums on the non-life insurance contracts over the dividends due policyholders (in their capacity as such) on those contracts. Net premiums and dividends to policyholders are to be computed as provided in section 823. Paragraph (2)(B)(i) of subsection (c) provides that the portion of the gross investment income allocable to non-life insurance reserves is to be an amount which bears the same ratio to gross investment income (reduced by the deduction for wholly exempt interest allowed by sec. 803 (c)(1)) as the nonlife reserves bear to the "qualified reserves" (defined under sec. 804(c)). The "excess" described in clause (ii) of subsection (c)(2)(B) could conceivably be a negative figure which would then reduce the amount to be determined under such subsection.

Subsection (d) of section 802 provides methods for computing the deduction for partially tax-exempt interest. Paragraph (1) of subsection (d) provides

(for the purpose of the normal tax computed under sec. 802(a)) a deduction for partially tax-exempt interest equal to an amount which bears the same ratio to the amount of the deduction provided by section 242 as the sum of the life insurance taxable income (determined under sec. 802(b)) and the net investment income allocable to non-life insurance reserves (determined under sec. 804(d)) bears to the net investment income. Since the net investment income is reduced by the reserve and other policy liability deduction, the deduction for partially tax-exempt interest is correspondingly reduced. For the purpose of the normal tax in computing the first partial tax under section 802(c)(2)(A), the deduction for partially tax-exempt interest is an amount which bears the same ratio to the amount of the deduction provided by section 242 as the life-insurance taxable income bears to the net investment income.

Subsection (e) of section 802 provides for a method of computing the alternative tax on capital gains in the case of a life insurance company which has non-life insurance reserves. Under section 1201(a), if the net long-term capital gain of a corporation exceeds its net short-term capital loss, then the alternative capital gains tax is computed by reference to such excess. Under subsection (e), the excess to be taken into account is an amount which bears the same ratio to the excess described in section 1201(a) as the non-life insurance reserves bear to the qualified reserves. In determining this excess, a net capital loss for any taxable year beginning before January 1, 1955, shall not be taken into consideration.

The "non-life insurance taxable income" of a life insurance company is defined in section 802(f) as the net investment income allocable to non-life insurance reserves increased by a proportionate share of the net capital gain allocable to this non-life insurance income and decreased by the proportionate share of the deductions for dividends received provided in sections 243, 244, and 245. In computing the net capital gain for purposes of this subsection, a net capital loss for any taxable year beginning before January 1, 1955, shall not be taken into account.

Section 803. Income and deductions

Section 803 provides rules and definitions for the determination of income and deductions to be used only in the case of life insurance companies.

Subsection (b) of section 803 defines "gross investment income." It starts with the definition of gross income, as provided by section 803(a)(2) of the Internal Revenue Code of 1954, and adds to that definition royalties and gross income from any trade or business (other than an insurance business) carried on by the life insurance company.

Subsection (b)(1) includes in the definition of "gross investment income" the gross amount of any income, received or accrued, during the taxable year, from interest, dividends, rents, and royalties. It is made clear that income includes the gross amount received in conjunction with the making of any lease, mortgage, or other instrument or agreement from which the life insurance company will derive interest, rents, or royalties, and the alteration or termination of any such lease, etc. Examples of such amounts would be a penalty for early payment of a mortgage and a bonus for entering into a lease. Any amount received in conjunction with an agreement which would be deemed a capital gain under other provisions of the Internal Revenue Code will not be included in gross investment income.

Under subsection (b)(2) of section 803, "gross investment income" also includes the gross income from any trade or business (other than an insurance business) carried on by the insurance company individually or in partnership. In determining the amount of income from such trade or business it is provided that any items described in section 803(b)(1) be excluded. Gross investment income does not include any gain from the sale or exchange of a capital asset. This exclusion applies also to any gain which is treated as a gain from the sale or exchange of a capital asset under other provisions of the Internal Revenue Code.

Section 803(c) defines "net investment income" (a term comparable to "taxable income" as used in section 803(g) of the Internal Revenue Code of 1954), as gross investment income (referred to in section 803(b)) less a number of deductions.

The deductions for tax-free interest, investment expenses, and depreciation are in substance the same as provided in section 803(g) of the 1954 Code. As under present law the insurance company is permitted to deduct taxes and other expenses (other than capital improvements) paid or accrued during the taxable

year exclusively on or with respect to real estate owned by the company. The bill adds a reference to section 164 to bring into operation here certain changes in the deductibility of taxes adopted in 1954 which are not now applied to insurance companies. Paragraph (5) of section 803(c) provides for a new deduction, that for depletion (and depreciation) allowed by section 611.

Paragraph (6) of this subsection allows the deductions attributable to any trade or business, the income from which is included in the life insurance company's gross investment income by reason of section 803(b)(2), except losses from (*a*) sales or exchanges of capital assets, (*b*) sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and (*c*) losses from the compulsory or involuntary conversion of property used in the trade or business. The allowable deductions may exceed the gross income from this business. Any part of the deductions provided in paragraph (6) will be disallowed to the extent attributable to the carrying on of the insurance business. An example of this disallowance could be provided by a life insurance company that operated a radio station primarily to advertise its own insurance services. A portion of the expenses of the radio station (corresponding to the ratio of the value of advertising furnished to the insurance company to the total value of services rendered by the station) will not be allowed as deductions. Paragraph (6) also excludes the deduction for net operating losses provided in section 172.

Unlike present law this bill omits the deduction for intercorporate dividends in computing the basic net investment income of a life insurance company. It is specified in paragraph (6) that none of the deductions allowed in part VIII of subchapter B shall be allowed as expenses of the noninsurance business.

Subsection (d), limiting the deductions related to real estate, and subsection (e), relating to amortization of premium and accrual of discount on bonds and other evidences of indebtedness are in substance the same as subsections (h) and (i), respectively, of section 803 of the Internal Revenue Code of 1954.

Section 804. Reserve and other policy liability deduction

Section 804 provides a new rule for determining the "reserve and other policy liability deduction" for the purpose of subpart A of part I of subchapter L of the 1954 Code. Subject to the limitations provided in subsection (b), subsection (a) defines the term "reserve and other policy liability deductions" (for the purposes of the subpart) as meaning the sum of the amounts determined by applying the following percentages to the excess of the net investment income over the net investment income allocable to non-life insurance reserves (determined under subsection (d)):

(1) 87½ percent of so much of the excess as does not exceed $1 million; and

(2) 85 percent of so much of the excess as exceeds $1 million.

Subsection (b) provides that the deduction for reserve and other policy liabilities shall not exceed an amount which is equal to the sum of the following:

(A) Two times the required interest on life insurance reserves (determined under sec. 805(c)(1));

(B) The required interest on reserves for deferred dividends (determined under sec. 805(c)(2));

(C) The amount of interest paid (as defined in sec. 804(d));

(D) The dividends to policyholders paid or declared (other than dividends on non-life insurance contracts referred to in subsection (d)(2)(A) of section 804; and

(E) In the case of a mutual assessment life insurance company or association such maximum is to be an amount equal to two times whichever of the following is the lesser:

(i) The amount of the net investment income on life insurance reserves described in subparagraph (A) or (B) of section 801(b)(3); or

(ii) 3 percent of the life insurance reserves so described.

The above sum must be reduced by the amount of the adjustment for policy loans provided in paragraph (2) of subsecttion (b). For the purposes of (D) the dividends to policyholders shall be construed as those paid, or those declared, according to the method of accounting regularly employed in keeping the books of the insurance company.

Paragraph (2) of subsection (b) provides for the application of an adjustment which will reduce the amount computed under paragraph (1) by an amount equal to the mean of the aggregates (at the beginning and end of the taxable year) of the outstanding policy loans with respect to contracts for which life insurance reserves are maintained, multiplied by the average rate of interest applicable to life insurance reserves.

Paragraph (3) of subsection (b) permits an insurance company, whose reserve and other policy liability deduction has been limited by paragraph (1) of this subsection, to take as a deduction an amount corresponding to the dividends received deductions provided in sections 243, 244, and 245 of the 1954 Code. Specifically, subparagraph (A) of the paragraph provides that where paragraph (1) of subsection (b) reduces the reserve and other policy liability deduction allowed by section 804 or 812, an insurance company will be allowed, in computing life insurance taxable income under section 802(b) or 811(b), an additional deduction corresponding to the dividends received deduction computed under the provisions of subparagraph (B).

The deduction computed under subparagraph (B) is to be an amount which bears the same ratio to the total intercorporate dividends received deductions provided in sections 243, 244, and 245 as the net investment income reduced as provided in the next paragraph, bears to the total net investment income.

In the above-mentioned computation, the net investment income is reduced by the sum of the net investment income allocable to nonlife insurance reserves (or for the purposes of section 811(d), the amount of the adjustment for certain reserves provided in section 813), and 100/85 of the maximum limitation determined under paragraphs (1) and (2) of subsection (b).

The provisions of paragraph (3) may be illustrated by the following example:

Company A (a life insurance company organized in 1945) has investment income of $300,000. In applying subsection (b) of section 804, the company has—

Required interest, $42,000, times 2	$84,000
Interest paid	1,000
Maximum reserve and other policy liability deduction	$85,000

Assuming the investment income allocable to non-life insurance reserves was $100,000 and the deduction under sections 243, 244, and 245 was $6,000, the total deduction for dividends received would be $4,000 determined in the following manner:

Deductions under 802(f), $6,000$\left(\frac{100,000}{300,000}\right)$	$2,000
Under 804 (b) (3), $6,000$\left(\frac{300,000-100,000-\frac{100}{85}(85,000)}{300,000}\right)$	2,000
Total deduction	4,000

The application of the preceding subsection may be illustrated by the following example:

The B life insurance company has net investment income of 300, of which 100 is allocable to non-life insurance reserves. The reserve and other policy liability deduction as computed under subsection (a) of section 804 is 87½ percent of 200 or 175. The company must then determine its maximum reserve and other policy liability deduction. The first element of this maximum relates to its interest on life insurance reserves which is computed as follows:

	Reserves, Jan. 1	Reserves, Dec. 31	Reserves, mean of year	Amount of required interest
Reserves at 2½ percent	900	1,100	1,000	25
Reserves at 3 percent	1,050	950	1,000	30
Total			2,000	55

The calculation of the maximum will include twice the sum of 25 and 30 or 110. There is also added interest paid on borrowings and on contracts not involving contingencies, which is 20, and dividends paid to policyholders of 10.

From 140 (the sum of 110, 20, and 10) there must be subtracted the adjustment for loans on policies involving life insurance reserves. The amount of such policy loans is 150 at the beginning of the year and 250 at the end or 200 as the mean. The adjustment for policy loans is determined by first dividing the reserve interest required (55) by the sum of the means of the life insurance reserves (2,000). This

average rate is thus 2.75 percent. This rate is multiplied by the mean policy loans of 200 yields an adjustment of 5.5. Thus the reserve and other policy liability deduction for the B company will be limited by subsection (b) and will be 140 less 5.5, or 134.5.

Section 804 (c) defined the term "qualified reserves" (as used in subpart A) as the sum of the following items:

(1) Life insurance reserves (as defined in section 801(b) plus 7 percent of that portion of such reserves as are computed on a preliminary term basis.

(2) The "nonlife insurance reserves" (defined in section 804(d)(2).

(3) The amounts (discounted at the rates assumed by the company) necessary to satisfy certain obligations under insurance and annuity contracts (including contracts supplementary thereto). Such amounts are to be included only if the above-mentioned obligations, when satisfied, will reflect an increment in the nature of interest, and such obligations do not involve life, health, or accident contingencies at the time with respect to which the computation is made under paragraph (3) of section 804(c).

(4) The amounts held at the end of the taxable year as reserves for dividends to policyholders, the payment of which dividends is deferred for at least 5 years from the date of the policy contract. Such amount shall not be deemed to include dividends payable during the year following the taxable year for which such computation is made.

(5) The dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts, including supplementary contracts.

(6) Premiums and annuity considerations received in advance, and liabilities for premium deposit funds and for annuity consideration deposit funds.

In applying subsection (c), the same item shall only be counted once. With the exception of paragraph (4) of section 804(c), the amount of any reserves (or portion thereof) for any taxable year (as used in section 804) shall be the mean of such reserves (or portion thereof) at the beginning and end of the taxable year.

Subsection (d) of section 804 provides for the definition of non-life insurance reserves and for the method of determining the amount of the net investment income allocable to such reserves.

Paragraph (1) of subsection (d) provides for the determination of the net investment income allocable to non-life insurance reserves as that amount which bears the same ratio to the net investment income as such reserves bear to the qualified reserves. Paragraph (2) of the subsection defines non-life insurance reserves as the sum of the unearned premiums and the unpaid losses (whether or not ascertained) on contracts other than life insurance, anuity and noncancelable health and accident insurance contracts, except any unearned premiums and unpaid losses which are included in the life insurance reserves as defined in section 801(b). The parenthetical phrase "whether or not ascertained" is intended as continuation of the treatment accorded unpaid losses under present law. The unearned premiums shall not be considered to be less than 25 percent of the net premiums written during the taxable year on such contracts.

Paragraph (3) of subsection (d) provides for an adjustment (under regulations prescribed by the Secretary or his delegate) with respect to certain non-life insurance contracts that do have some life insurance reserves.

Section 805. Special interest deduction

Section 805 provides for a special interest deduction (comparable to the reserve interest credit provided in section 805(b) of the Internal Revenue Code of 1954) to be used when computing the tax imposed by section 802. The deduction is provided for life insurance companies whose net investment incomes are insufficient or barely sufficient to meet their required interest commitments.

The deduction is determined as under present law, with some minor changes. Under present law if the ratio of adjusted taxable income to required interest is less than 1.00 the company receives an additional deduction of 50 percent of the income subject to the life insurance tax. To conform the numerator of this ratio to the current bill an adjusted net investment income is used described in subsection (b). To retain the effect of the provision under present law the ratio is multiplied by the net investment income reduced by the sum of net investment income allocable to non-life insurance reserves and the reserve and other policy liability deduction. As under present law reduced allowances are made where the ratio is between 1.00 and 1.05.

A minor change in the definition of required interest is made. Under present law the required interest with respect to the reserve for deferred dividends is deemed to be 2 percent. Under the bill the actual interest rate is used.

SUBPART B.—1942 FORMULA

Sections 811, 812, and 813 provide that after 1955, certain provisions of the Revenue Act of 1942 are to be combined with certain of the new provisions set forth in subpart A. The particular 1942 provisions that would come back into operation would be the method of determining the reserve and other policy liability deduction by reference to the Secretary's ratio (section 812) and the computation of income on non-life insurance business by means of applying 3¼ percent to certain reserves (sec. 813).

The features of subpart A which are made permanent are:

(1) The new definitions relating to investment income;
(2) Denial of the dividends received credit;
(3) The maximum limit on the reserve and other policy liability deduction;
(4) The adjustment for policy loans in the 50 percent test used to define a life insurance company; and
(5) The special interest deduction.

Section 811. Tax imposed

Subsections (a) and (b) of section 811 are in substance the same as section 802(a) of the Internal Revenue Code of 1954, except that the special interest deduction is allowed.

Subsection (c) of section 811 provides an adjustment in computing the special interest deduction. Under this subsection, the computations under the specified provisions of the new section 805 will be made by substituting the amount of the adjustment for certain reserves provided in section 813 for the net investment income allocable to non-life insurance reserves. For purposes of section 805(b), the substitution will be made after the net investment income has been computed without the reduction for wholly exempt interest. Under the amendment made by your committee, in applying section 805(b) (2) with respect to subpart B, the amount taken into account will be 50 percent of the amount of the adjustment for certain reserves, in lieu of 50 percent of the net investment income allocable to non-life insurance reserves.

Section 812. Reserve and other policy liability deduction

Section 812 is in substance the same as section 204(a) of the Internal Revenue Code of 1954. The term "net investment income" is substituted for the term "taxable income" wherever such term is used in section 804 of the 1954 Code.

Subsection (b) contains definitions corresponding to the definitions found in subsections (c), (d), (e), and (f) of section 803 of the 1954 Code.

Subsection (c) applies the same maximum limit to the reserve and other policy liability deduction allowed by section 812(a) as the maximum limit applied by section 804(b).

Section 813. Adjustment for certain reserves

Section 813, in substance the same as section 806 of the Internal Revenue Code of 1954, provides for an adjustment for certain reserves in the case of a life insurance company writing contracts other than life insurance, annuity, and noncancelable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancelable health and accident insurance).

SUBPART C.—MISCELLANEOUS PROVISIONS

Section 816. Foreign life insurance companies

Section 816 is in substance the same as section 807 of the Internal Revenue Code of 1954.

Section 817. Denial of double deductions

Section 817 applies to part I the prohibition against double deductions found in section 803(j) of the Internal Revenue Code of 1954.

Section 818. Certain new insurance companies

Section 818(a) provides an alternative tax treatment for a life insurance company if the taxable year begins not more than 4 years after the first day on which the company was authorized to do business as an insurance company. If an insur-

ance company so qualifies for the taxable year, its life insurance taxable income (for purposes of subpart A) shall not exceed the amount of the net gain from operations (after dividends to policyholders and before Federal income tax) reduced by the net investment income allocable to non-life insurance reserves and the special deduction for dividends received provided in subsection (c). Similarly, if a company so qualifies for purposes of subpart B, its life insurance company taxable income shall not exceed the amount of the net gain from operations (after dividends to policy holders and before Federal income tax) reduced by the special deduction for dividends received provided in subsection (c). Subsection (a) further provides that the net gain from operations (after dividends for policyholders and before Federal income tax) mentioned above shall be computed in the manner required for purposes of the annual statement approved by the National Convention of Insurance Commissioners.

Subsection (b) limits the relief to new insurance companies under the alternative tax treatment of this section by providing that the section shall not reduce the tax for any taxable year below the amount which (but for this section) would be imposed by section 802 or section 811 (as the case may be) computed without the limitation upon the reserve and other policy liability deduction contained in section 804(b) or section 812(c).

Subsection (c) provides the special rule for the dividends-received deduction referred to in paragraph (1)(B)(ii) and paragraph 2 of subsection (a). The deduction shall be an amount computed under section 804(b)(3), except that for the purposes of such computation, the maximum limitation referred to in section 804(b)(3)(B)(ii) shall be—

(1) in the case where the tax imposed by section 802 applies, the amount by which the net investment income (reduced by the net investment income allocable to non-life insurance reserves) exceeds the net gain from operations (after dividends to policyholders and before Federal income tax) reduced by the net investment-income allocable to non-life insurance reserves, or

(2) in the case where the tax imposed by section 811 applies, the amount by which the sum of the net investment income and the amount of the adjustment for certain reserves (provided in section 813) exceeds the net gain from operations (after dividends to policyholders and before Federal income tax).

The application of section 818 is shown by the following example:

The A life insurance company, which received its authorization to do business as an insurance company in 1953, in the taxable year 1955 received net investment income of $300,000, of which $200,000 was dividends (thus, the deduction that would be allowed by sections 243, 244, and 245 is $170,000). There were no nonlife insurance reserves. Its required interest for 1955 was $42,500. Its net gain from operations after dividends to policyholders and before Federal income tax was $200,000.

Under the provisions of section 802(b) and section 804 the life insurance taxable income is computed as follows:

Net investment income		$300,000
Maximum reserve and other policy liability deduction minus required interest ($42,500) times 2	$85,000	
Dividends-received deduction under sec. 804(b)(3): $\frac{300{,}000-\frac{100}{85}(85{,}000)}{300{,}000}\times(170{,}000)$	113,333	
		198,333
Life insurance taxable income		101,667

Because the A company qualifies under the provisions of section 818 it will compute its life insurance taxable income as follows:

Net gain from operations (after dividends to policyholders and before Federal income tax)		$200,000
Dividends-received deduction provided by sec. 818(c): $\frac{300{,}000-\frac{100}{85}(100{,}000)}{300{,}000}\times(170{,}000)$		103,333
Life insurance taxable income		96,667

The 100,000 which was multiplied by 100/85 is the net investment income ($300,000) less the net gain from operations, and so forth ($200,000).

Subsection (b) provides that in no case shall the life insurance taxable income be less than the net investment income reduced by 87½ percent (85 percent of the amount over $1 million).

SECTION 3. ADJUSTMENT TO INVESTMENT INCOME OF INSURANCE COMPANIES OTHER THAN LIFE

Subsection (a) of section 3 contains amendments to part II of subchapter L of chapter 1 of the Internal Revenue Code of 1954 (relating to mutual insurance companies other than life). These amendments conform the investment income which is used as a tax base in the case of these mutual insurance companies to the revised concept of investment income which will apply to life insurance companies under the new part I. The principal changes are the express inclusion of royalties, and the income from a trade or business other than the insurance business together with the deductions attributable thereto. No change is made in the availability of the deduction for dividends received.

Subsection (b) of section 3 contains amendments to part III of subchapter L (relating to stock insurance companies other than life). Since these companies are in effect, taxed on the regular corporate basis, no change was necessary in the definition of their investment income. However, technical amendments were made to permit them to take a deduction for depletion (which was not specifically allowed by the Internal Revenue Code of 1954), to correct the special capital loss deduction provisions, and to correct a cross reference to the definition of life insurance reserves.

SECTION 4. ANNUAL ACCOUNTING PERIOD OF INSURANCE COMPANIES TO BE A CALENDAR YEAR

This section adds section 843 to part IV of subchapter L of chapter 1 of the Internal Revenue Code of 1954. Section 843 provides that for the purposes of subtitle A of the Internal Revenue Code of 1954 the annual accounting period for each insurance company subject to a tax imposed by subchapter L shall be the calendar year.

SECTION 5. TECHNICAL AMENDMENTS

This section makes certain technical amendments to provisions of the Internal Revenue Code of 1954 outside of the first three parts of subchapter L to conform those provisions to the changes in subchapter L made by sections 2 and 3 of the bill.

Paragraph (2) of this section amends paragraph (16) of section 501 (c) of the Internal Revenue Code, which provides an exemption from tax for certain small mutual insurance companies and associations. Under present law, such a company or association is exempt if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000. Under the amendment, the broader concept of the gross investment income contained in the bill is substituted for interest, dividends, and rents.

SECTION 6. EFFECTIVE DATE

Section 6 provides that the amendments made by the bill shall apply only to taxable years beginning after December 31, 1954.

SECTION 7. SAVINGS PROVISIONS

Section 7 provides that no addition to the tax shall be made under section 6655 of the 1954 Code with respect to the estimated tax for a taxable year beginning in 1955 for any taxpayer subject to tax under the provisions of section 802 or 807 of the 1954 Code (as such sections were in effect before the enactment of H. R. 7201). In the case of a taxpayer subject to tax under section 821 of the 1954 Code (imposing a tax on certain mutual insurance companies) any addition to the tax under section 6655 of the 1954 Code with respect to estimated tax for a taxable year beginning in 1955 shall in no case be larger than such addition would have been if this act had not been enacted.

[H. R. 7282—P. L. 399]

AMENDMENT OF SECTION 117(c)(1)(A) OF THE INTERNAL REVENUE CODE OF 1939

[House of Representatives Report No. 1356, Eighty-fourth Congress, First Session]

[July 23, 1955]

Mr. Herlong, from the Committee on Ways and Means, submitted the following report [to accompany H. R. 7282]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 7282) relating to the allowance of the credits for dividends received, for dividends paid, and for a Western Hemisphere trade corporation in computing the alternative tax of a corporation with respect to its capital gains, having considered the same report favorably thereon with an amendment and recommend that the bill, as amended, do pass.

The amendment is as follows:

Page 1, line 10, after the period insert:

No interest shall be allowed or paid on any overpayment resulting from such amendment.

PURPOSE OF BILL

This bill provides that in the computation of the credits for intercorporate dividends received, for dividends paid on certain preferred stock, and for Western Hemisphere trade corporations, a corporation's net income under the 1939 Code is to be determined without reduction for the excess of the net long-term capital gain over the net short-term capital loss.

REASONS FOR BILL

The credit for intercorporate dividends received under the 1939 Code was 85 percent of the dividends but not to exceed 85 percent of the adjusted net income computed without regard to the deduction allowed for a net operating loss. Similarly, the credit allowed for dividends paid on certain preferred stock of public utilities was limited to a percentage of the amount of dividends paid, or to the percentage applied to the adjusted net income less the credits for dividends received. In the case of a Western Hemisphere trade corporation the credit was limited to a percentage of the normal tax net income. In all of these cases the question has arisen as to whether net income for purposes of computing the limitation with respect to the intercorporate dividends-received credit or the basis on which the other credits are computed, is to include capital gains. Capital gains under section 117 of the 1939 Code may (and under existing rates practically always are) subject to an alternative tax of 25 percent in lieu of inclusion in the base on which the regular corporate income tax is computed.

Apparently prior to 1952 the Internal Revenue Service accepted the computation of these credits based upon net income including capital gains and even the recent rulings do not attempt to upset these computations. In the instructions accompanying the 1952 return from (and in 1953 a footnote was also added on the return) the Service indicated that it did not consider that net income for the purposes of computing these credits should properly include capital gains. It was not until 1954 in Revenue Ruling 54–28 [C. B. 1954–1, 123] that the position of the Internal Revenue Service on this matter was dealt with in a definitive ruling. Then this ruling was made applicable to 1952 and subsequent years. Your committee believes that the position in the ruling should be reversed for years prior to 1954 in order to provide a consistent policy for the period of the 1939 code. Under these circumstances and because your committee believes that since capital gains may be included in the ordinary corporate tax base and are excluded only in arriving at an alternative, as distinct from a separate, tax the inclusion of such capital gains in income for purposes of computing these credits under the 1939 code appears entirely reasonable.

EXPLANATION OF BILL

Under this bill corporations, for taxable years beginning after December 31, 1951, and before January 1, 1954, may compute the intercorporate dividends re-

ceived (sec. 26 (b) of the 1939 code), the credit for dividends paid on certain preferred stock (sec. 26 (h) of the 1939 code), and the credit for Western Hemisphere trade corporations (sec. 26 (i) of the 1939 code) on the basis of the net income of the corporation without reduction for the excess of the net long-term capital gain over the net short-term capital loss.

Under an amendment made by your committee interest will not be allowed on any refunds resulting from the enactment of this bill.

This bill was reported unanimously by your committee.

[H. R. 7282—P. L. 399]

RELATING TO THE ALLOWANCE OF THE CREDITS FOR DIVIDENDS RECEIVED, FOR DIVIDENDS PAID, AND FOR A WESTERN HEMISPHERE TRADE CORPORATION IN COMPUTING THE ALTERNATIVE TAX OF A CORPORATION WITH RESPECT TO ITS CAPITAL GAINS

[Senate Report No. 1378, Eighty-fourth Congress, Second Session. Calendar No. 1398]

[January 12, 1956]

Mr. Byrd, from the Committee on Finance, submitted the following report [to accompany H. R. 7282]:

The Committee on Finance, to whom was referred the bill (H. R. 7282) relating to the allowance of the credits for dividends received, for dividends paid, and for a Western Hemisphere trade corporation in computing the alternative tax of a corporation with respect to its capital gains, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

By virture of this action, the Committee on Finance accepts the report of the Committee on Ways and Means, which is as follows:

[See House Report No. 1356, page 981 this Bulletin]

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[H. R. 7364—P. L. 400]

DOCUMENTARY STAMP TAX

[House of Representatives Report No. 1497, Eighty-fourth Congress, First Session]

[July 27, 1956]

Mr. McCarthy, from the Committee on Ways and Means, submitted the following report [to accompany H. R. 7364]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 7364) relating to the application of the documentary stamp tax to transfers of certain installment obligations, having considered the same report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 1, line 9, strike out "Certain Installment Obligations" and insert: "Installment Purchase of Obligations".

Page 1, line 11, strike out "requested" and insert: "required".

Amend the title so as to read:

A bill relating to the application of the documentary stamp tax to transfers of certain obligations paid for in installments.

PURPOSE OF BILL

This bill as reported reenacts an exemption from the documentary stamp tax on transfers of certain certificates of indebtedness, effective as of January 1, 1955, the effective date of subtitle D of the 1954 code. This exemption was inadvertently omitted from the 1954 code.

REASONS FOR BILL

Under section 1801 of the Internal Revenue Code of 1939, a tax was imposed upon the issuance of certain certificates of indebtedness. The tax specifically was inapplicable to any instrument with respect to which the obligee was required to make payments in installments and was not permitted to make in any year a payment of more than 20 percent of the cash amount to which the obligee was entitled upon maturity of the instrument. Section 3481 of the 1939 code imposed a documentary stamp tax on the transfer of instruments which were subject to the stamp tax at the time of their issue.

It was the expressed intention to continue these provisions in the 1954 code. Under the 1954 code, the stamp tax on issuance is imposed by section 4311. This tax, as under the 1939 code, is made inapplicable under section 4315 (a) to the securities described above. However, the stamp tax on transfer of certificates of indebtedness, under section 4331, is imposed on "any certificates of indebtedness, isued by a corporation" rather than on instruments subject to tax on issuance. Thus in the case of transfers, the exemption applicable to the described certificates was omitted.

Your committee is unanimous in reporting this bill, as amended.

[H. R. 7364]

RELATING TO THE APPLICATION OF THE DOCUMENTARY STAMP TAX TO TRANSFERS OF CERTAIN OBLIGATIONS PAID FOR IN INSTALLMENTS

[Senate Report No. 1379, Eighty-fourth Congress, Second Session. Calendar No. 1399]

[January 12, 1956.]

Mr. Byrd, from the Committee on Finance, submitted the following report [to accompany H. R. 7364]:

The Committee on Finance, to whom was referred the bill (H. R. 7364) relating to the application of the documentary stamp tax to transfers of certain obligations paid for in installments, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

By virtue of this action, the Committee on Finance accepts the report of the Committee on Ways and Means, which is as follows:

[See House Report No. 1497, page 982 this Bulletin]

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[H. R. 8780—P. L. 466]

RELIEF FROM TAXES ON GASOLINE AND SPECIAL FUELS USED ON FARMS

[House of Representatives Report No. 1684, Eighty-fourth Congress, Second Session]

[January 26, 1956]

Mr. Cooper, from the Committee on Ways and Means, submitted the following report [To accompany H. R. 8780]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 8780) to amend the Internal Revenue Code of 1954 to relieve farmers from excise taxes in the case of gasoline and special fuels used on the farm for farming purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. GENERAL STATEMENT

This is a bill to relieve farmers of the burden of the excise taxes on the gasoline and special fuels used on their farms for farming purposes. The

relief in the case of the gasoline tax is accomplished by providing for annual refunds payable by the Federal Government directly to the farmers. It is estimated that this will provide farmers with approximately $60 million of tax relief each year.

The depressed situation in agriculture probably constitutes the most important domestic problem before Congress at the present time. Although the industrial segment of the economy is operating at a high level, both farm prices and farm income are depressed. The decline in farm income has now continued for several years and unless reversed is likely to constitute a threat to the well-being of the entire economy.

The farmer today is caught in a severe price-cost squeeze. At the same time farm prices are declining, the costs of the articles he must buy have been rising. This problem must be met on several fronts, one of these involving the reduction of the costs which the farmer must pay. One of the costs which the farmer must meet is the Federal 2-cents-a-gallon tax presently imposed on the gasoline he uses on his farm. This bill reduces the farmers' operating costs by removing the taxes in the case of gasoline and special fuels used by farmers but in both cases only with respect to the use on a farm for farming purposes.

II. SUMMARY OF PROVISIONS OF THE BILL

Section 1, the basic section of the bill, provides for the refund of tax with respect to gasoline used on farms.

A. Gasoline

In the new code section 6420, it is provided that refunds are to be paid to purchasers of gasoline used on a farm for farming purposes. The refund under present tax rates will be 2 cents (1½ cents on and after April 1, 1956, if the reduced rates go into effect), multiplied by the number of gallons of gasoline used for the prescribed purposes.

The phrase "used on a farm for farming purposes" is defined as including only gasoline used—

(1) in carrying on a trade or business,
(2) on a farm in the United States, and
(3) for farming purposes.

The terms "farm" and "farming purposes" as used here are also defined terms. These definitions are described subsequently.

B. Time and Manner of Making Refund

The refunds with respect to gasoline are to be provided on an annual period ending on June 30. The claim is to be filed on or before September 30 of each year, and is to be filed by the farmer directly with the appropriate office of the Internal Revenue Service.

C. Definition of Farm and Farming Purpose

As indicated previously, refunds are to be available with respect to gasoline only where used in carrying on a trade or business, on a farm in the United States, and for farming purposes. The term "farm" as used here is defined as including stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards. This definition is the same as that presently in the 1954 Code with respect to the Federal Insurance Contributions Act.

The term "farming purposes" is also defined in the bill. It includes use by any person in connection with cultivation of the soil, or the raising or harvesting of agriculture or horticultural commodities, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife. As a result, gasoline used by custom operators or other independent contractors performing a service on a farm in connection with cultivating the soil or raising or harvesting agricultural or horticultural commodities may be included in a refund claim. The term "farming purposes" also includes the handling, drying, packing, grading, or storing of agricultural or horticultural commodities but in these cases only if the work is done by the owner, tenant, or operator and only if such person produced more

than half of the commodity receiving this treatment during the year. This means that with respect to handling, drying, packing, grading, or storing of these commodities services performed by custom operators or other independent contractors, even though on the farm, are not the type with respect to which a refund may be claimed.

The definition of "farming purposes" also includes the planting, cultivating, caring for, or cutting of trees, as well as the preparation (other than sawing logs into lumber, chipping and other milling operations) of trees for the market but in this case only if the work is performed by the owner, tenant, or operator of a farm and also only if it is incidental to farming operations. Still another category of work included in the farming purpose definition is that done by the owner, tenant, or operator of the farm in connection with the operation, management, conservation, improvement, or maintenance of the farm, including farm buildings, tools, and equipment.

D. Diesel Fuel and Special Motor Fuels

Section 2 of the bill provides relief for diesel fuel and special motor fuels (such as propane, butane, and so forth, including what is sometimes referred to as hot tractor fuel). In the case of diesel fuel, present law already provides that this tax is to apply only when the fuel is used in highway vehicles. The bill in this case provides an exemption with respect to diesel fuel used in any of these highway vehicles where the vehicles are used on a farm for farming purposes.

In the case of special motor fuels, present law provides a tax only when the fuel is for use in a motor vehicle, motor boat, or airplane. The bill provides an exemption for such use of special motor fuel when it is used on a farm for farming purposes.

Even under present law diesel fuel and special motor fuel are exempt from tax when used in a farm tractor since farm tractors have been held not to be motor vehicles under existing law.

Provision is also made for credits or refunds with respect to diesel fuel and special motor fuels which are used on a farm for farming purposes and have been sold taxpaid. In this case the credit or refund is to be obtained by processing the claim back through the person making the first taxpaid sale. This is the same procedure already in use in the case of other refunds or credits for diesel fuel and special motor fuel.

E. Civil Penalty for Excessive Claims

Section 3 of the bill provides a special civil penalty for excessive claims for refunds with respect to gasoline. The new provision (in addition to any of the regular criminal penalties which may be applicable) provides that if a claim for a gasoline refund is excessive, a civil penalty may be imposed unless it can be shown that the claim for the excessive amount is due to reasonable cause. Section 3 is intended to be in addition to, and not in lieu of, other methods of enforcement now provided by existing law. The penalty imposed by section 3 is two times the excess amount claimed but not less than $10. This penalty, as well as the excessive amount itself, is to be assessed and collected as a tax.

III. TECHNICAL EXPLANATION OF THE BILL

Section 1 of the bill amends subchapter B of chapter 65 of the Internal Revenue Code of 1954 by renumbering section 6420 as section 6421 and inserting a new section 6420.

SECTION 6420. RELIEF FROM THE EXCISE TAX ON GASOLINE

Subsection (a).—Subsection (a) of the new section 6420 provides that the Secretary or his delegate shall pay to the ultimate purchaser of gasoline used on a farm for farming purposes the amount determined by multiplying (1) the number of gallons so used, by (2) the rate of tax on gasoline under section 4081 which applied on the date he purchased such gasoline. The meaning of the terms used on a farm for farming purposes, farm, farming purposes, and gasoline, are set forth in subsection (c) of section 6420. Interest is not allowable with respect to payments made pursuant to the provisions of section 6420. It will not be necessary for the claimant to show that the tax was in fact paid by the producer of the gasoline. In case of a change in rate of tax, the gasoline which is first purchased by the claimant will, as a general rule, be deemed to have been first used for purposes of claiming the farm-use payment.

Subsection (a) of section 6420 also provides that only the ultimate purchaser shall receive the payment for the farm use of gasoline. This makes it clear that prior purchasers of such gasoline will not be entitled to claim payment. For example, if farmer A purchases 200 gallons of gasoline and subsequently sells 50 gallons of such gasoline to farmer B who uses the fuel on his farm for farming purposes, only farmer B may claim payment with respect to the 50 gallons of gasoline so used by him inasmuch as he is the ultimate purchaser. The payment for farm use is to be made to the purchaser of the gasoline even though he is not the user of the gasoline. For instance, in the absence of special circumstances, a lessor of a farm who purchased the gasoline and furnished it to his tenant for use on the farm for farming purposes is the one who is authorized under the bill to claim payment if the gasoline is so used.

If a vehicle or equipment is used both on a farm and off the farm, or if it is used on a farm both for farming and nonfarming purposes, the claimant is entitled to payment under section 6420 only with respect to that portion of the gasoline which was consumed on the farm for farming purposes. Accordingly, if a truck used on a farm in connection with the cultivating or harvesting of agricultural commodities is also used on the highways (whether to deliver commodities to market or otherwise), the gasoline used in operating the truck on the highways is not to be taken into account in computing the payments authorized by section 6420.

Subsection (b).—Subsection (b) relates to the time for filing a claim and the period to be covered by such claim. Not more than one claim may be filed under this section by any person with respect to gasoline used during the 1-year period ending on June 30 of any year. This subsection also provides that no claim is to be allowed with respect to any 1-year period unless the claim is filed on or before September 30 of the calendar year in which the 1-year period ends. Thus, for example, for the 1-year period ending June 30, 1957, the purchaser may make a claim for any gasoline used (on a farm for farming purposes) after June 30, 1956, and before July 1, 1957. Such claim must be filed on or before September 30, 1957. It should be noted that under subsection (g) of the new section 6420, claims filed under this section before October 1, 1956, will cover only gasoline purchased after December 31, 1955. The same limitation will apply in the case of claims for any subsequent period, that is to say, no payment is allowable under this section at any time for gasoline purchased before January 1, 1956.

Subsection (c).—Paragraph (1) of subsection (c) of the new section 6420 provides that gasoline shall be treated as used on a farm for farming purposes only if used (1) in carrying on a trade or business, (2) on a farm situated in the United States (that is, the several States, Alaska, Hawaii, and the District of Columbia), and (3) for farming purposes. The term "trade or business" has the same meaning as when used in section 162 of the 1954 Code in connection with expenses paid or incurred in carrying on any trade or business.

Paragraph (2) of subsection (c) defines the term "farm" to include stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards. This definition is the same as that contained in section 3121(g) of the 1954 Code.

Under paragraph (3) of subsection (c) gasoline is to be treated as used for farming purposes only if used as provided in subparagraph (A), (B), (C), or (D). Under subparagraph (A), gasoline is used for farming purposes if used by any person in connection with cultivating the soil, or in connection with raising or harvesting any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife. Gasoline used on a farm in connection with the production or harvesting of maple sap or in connection with the production or harvesting of crude gum (oleoresin) from a living tree is treated as used for farming purposes; but gasoline used in the processing (as distinguished from the gathering) of maple sap into maple sirup or maple sugar or used in the processing of crude gum (oleoresin) into gum spirits of turpentine and gum rosin is not so treated, even though such processing operations are conducted on a farm.

Under subparagraph (B) gasoline is to be treated as used for farming purposes, if used by the owner, tenant, or operator of a farm in handling, drying, packing, grading, or storing any agricultural or horticultural commodity in its unmanufactured state; but only if such owner, tenant, or operator produced

more than one-half of the commodity which he so treated during the 1-year period with respect to which claim is filed under this section. The term "operator of a farm" means a person in possession of a farm and engaged in the operation of such farm. Whether use by the owner or tenant qualifies under this subparagraph (or subpar. (C) or (D)) is to be determined without regard to whether the owner or tenant is in possession of the farm and without regard to whether he is the operator of the farm. Gasoline used in operations other than those of the prescribed character (such as canning, freezing, packaging, and processing operations) is not considered to be used for farming purposes within the meaning of subparagraph (B). The term "commodity" refers to a single agricultural or horticultural product, that is, all apples are to be treated as a single commodity, while apples and peaches are to be treated as two separate commodities. The operations with respect to each such commodity are to be considered separately in applying the "one-half" test described in the first sentence of this paragraph.

Under subparagraph (C), gasoline is to be treated as used for farming purposes if used by the owner, tenant, or operator of a farm, in connection with the planting, cultivating, caring for, or cutting of trees or in the preparation (other than milling) of trees for market; but only if such operations are incidental to farming operations. These operations include the felling of trees and cutting them into logs or firewood but do not include sawing logs into lumber, chipping, or other milling operations.

Operations of the character specified in subparagraph (C) must be incidental to the farming operations of such farm or to the farming operations of the owner, tenant, or operator of the farm. The word "incidental" is used in the statute in order to insure that the volume of the operations of the specified character will be, by comparison with the total farming operations involved, of a minor nature.

Under subparagraph (D), gasoline is to be treated as used for farming purposes if used by the owner, tenant, or operator of a farm in connection with the operation, management, conservation, improvement, or maintenance of such farm and its tools and equipment. These operations may include clearing land, repairing, painting, irrigating, and other activities which contribute in any way to the conduct of the farm, as such, as distinguished from any other enterprise in which the owner, tenant, or operator may be engaged. Since the gasoline must be used by the owner, tenant, or operator of the farm to which the operations relate, gasoline used in operations of the prescribed character by a commercial painting concern, for example, which contracts with a farmer to renovate his farm properties is not to be taken into account in computing claims under this section.

Under paragraph (4) of the subsection, the term "gasoline" is given the same meaning as when used in section 4082(b). That is to say, the term means all products commonly or commercially known or sold as gasoline (including casinghead and natural gasoline).

Subsection (d).—Subsection (d) provides two conditions which must be observed in determining the amount of any payment to be made under section 6420.

First, it prohibits payment of any amount with respect to any gasoline which the Secretary or his delegate determines was exempt from the tax imposed by section 4081 of the 1954 code. Thus, gasoline purchased by a State tax-free by virtue of section 4224 of the 1954 Code and used on a State prison farm for a farming purpose cannot be included in determining any amount claimed under section 6420.

Secondly, it provides that any amount that would otherwise have been payable under section 6420 with respect to any gasoline shall be reduced by any other amount which the Secretary or his delegate determines is payable under section 6420 or is refundable under any other provision of the 1954 Code to any person with respect to such gasoline.

Subsection (e).—Paragraph (1) of subsection (e) provides that all provision of law, including penalties, applicable in respect of the tax imposed by section 4081 shall, insofar as applicable and not inconsistent with section 6420, apply in respect of the payments provided for in section 6420 to the same extent as if such payments constituted refunds of overpayments of the tax so imposed. Under this provision (to mention some, but not all, of the provisions which will apply) sections 6514 (relating to credits or refunds after period of limitations), 6532 (relating to periods of limitation on suits), 7405 (relating to action for recovery

of erroneous refunds), and 7422 (relating to civil actions for refunds by taxpayers) of the 1954 Code apply.

However, by reason of subsection (e)(3), the Secretary or his delegate may not exercise his discretionary power under section 7504 of the 1954 Code to disregard a fractional part of a dollar.

For the purpose of determining the correctness of any claim made under this section, or of any payment made pursuant to such claim, subsequent (e)(2) makes applicable paragraphs (1), (2), and (3) of section 7602 of the 1954 Code, relating to the examination of books and witnesses, as if the claimant were the person liable for tax.

Subsection (f).—Subsection (f) provides that the Secretary or his delegate may by regulations prescribe the conditions, not inconsistent with the provisions of section 6420, under which payments may be made under section 6420. Some of the conditions that might be appropriately prescribed by regulations are, for example:

(1) The type of records that the farmer will be required to keep;
(2) The form on which the claim must be filed;
(3) The information to be contained in such claim; and
(4) The evidence necessary to support such claim.

Subsection (g).—Subsection (g) provides that payments under section 6420 may be made only with respect to gasoline purchased by the ultimate purchaser after December 31, 1955. Thus, gasoline which was purchased by a farmer before January 1, 1956, but which he used on or after such date, may not be included in any claim under this section.

Subsection (h).—Subsection (h) provides appropriate cross references to other provisions of the 1954 Code.

SECTION 2. RELIEF FROM TAXES ON DIESEL FUEL AND SPECIAL MOTOR FUEL

Section 2 of the bill provides for an exemption from (or a credit or refund with respect to) the excise taxes on diesel fuel and special motor fuels, in cases involving the use of such liquids on a farm for farming purposes.

Subsection (a).—Paragraph (1) adds a new subsection (d) to section 4041 of the 1954 Code. Paragraph (1) of the new subsection (d) provides that no tax shall apply to diesel fuel or special motor fuel sold for use on a farm for farming purposes and that no tax shall apply to the use of such fuels on a farm for farming purposes. Under paragraph (2) of the new subsection (d), the test of whether diesel fuel or any special motor fuel is used on a farm for farming purposes is the same as the test set forth with respect to gasoline in section 6420(c). Paragraph (2) of section 2(a) of the bill provides that the amendment made by paragraph (1) of section 2(a) of the bill shall take effect on the day after the date of enactment of the bill.

Subsection (b).—Subsection (b) of section 2 of the bill makes a corresponding amendment to section 6416(b)(2)(C) of the 1954 Code to provide (in addition to the other situations in which a credit or refund may be claimed) that credit or refund shall be made if such diesel fuel or special motor fuel was (within the meaning of paragraphs (1), (2), and (3) of section 6420(c) used on a farm for farming purposes. This amendment will apply with respect to liquids sold after December 31, 1955.

SECTION 3. CIVIL PENALTY

Section 3 of the bill adds a new section 6675 to the 1954 Code which provides an assessable penalty for claiming an excessive amount under section 6420. Under section 6675 a person making a claim under section 6420 for an excessive amount is liable, unless it is shown that the claim for such excessive amount is due to reasonable cause, to a penlty equal to 2 times the excessive amount or $10, whichever is greaer. This penalty is in addition to any criminal penalty provided by law.

SECTION 4. TECHNICAL AMENDMENTS

Subsections (a), (b)(2), (c), (d), (e), (f), and (g) of section 4 of the bill make conforming changes in tables of sections and add appropriate cross references.

Subsection (b)(1) of section 4 of the bill adds a new section 6206 to the 1954 Code. Section 6206 provides that any portion of a payment made under section

6420 which constitutes an excessive amount (as defined in sec. 6675(b)), and any civil penalty provided by section 6675, may be assessed and collected as if it were a tax imposed by section 4081 and as if the person who made the claim were liable for such tax. Section 6206 also provides that the period for assessing the excessive amount, and for assessing the penalty, shall be 3 years from the last day prescribed for the filing of the claim under section 6420 (that is, 3 years from September 30).

Subsections (h) and (i) of section 4 of the bill amend the provisions relating to service and enforcement of a summons to bring into the scope of such provisions a summons issued under the authority of subsection (e) (2) of section 6420.

[H. R. 8780—P. L. 466]

RELIEF FROM TAXES ON GASOLINE AND SPECIAL FUELS USED ON FARMS

[Senate Report No. 1609, Eighty-fourth Congress, Second Session, Calendar No. 1631]

[March 2, 1956]

Mr. Byrd, from the Committee on Finance, submitted the following report [To accompany H. R. 8780]:

The Committee on Finance, to whom was referred the bill (H. R. 8780) to amend the Internal Revenue Code of 1954 to relieve farmers from excise taxes in the case of gasoline and special fuels used on the farm for farming purposes, having considered the same, report favorably thereon with amendments and recommend that the bill, as amended, do pass.

I. GENERAL STATEMENT

This bill relieves farmers of the burden of the excise taxes on the gasoline and special fuels used on their farms for farming purposes. The relief in the case of the gasoline tax is accomplished by providing for annual refunds payable by the Federal Government directly to the farmers. It is estimated that this will provide farmers with approximately $59 million of tax relief each full year of operation.

Your committee made one substantive amendment to the House bill. Refunds with respect to the gasoline tax are not to be allowed for custom operators (i. e., independent contractors) with respect to cultivating, harvesting, etc., operations. However, where farmers perform similar services for their neighbors refunds may be claimed if these operations for neighbors constitute less than half of the total of these operations of the farmer. Custom operators are excluded from the benefits of this provision by your committee because there is no assurance that they will pass the benefit of the refunds on to the farmers.

The depressed situation in agriculture probably constitutes the most important domestic problem before Congress at the present time. Although the industrial segment of the economy is operating at a high level, both farm prices and farm income are depressed. The decline in farm income has now continued for several years and unless reversed is likely to constitute a threat to the well-being of the entire economy.

The farmer today is caught in a severe price-cost squeeze. At the same time farm prices are declining, the costs of the articles he must buy have been rising. This problem must be met on several fronts, one of these involving the reduction of the costs which the farmer must pay. One of the costs which the farmer must meet is the Federal 2-cents-a-gallon tax presently imposed on the gasoline he uses on his farm. This bill reduces the farmers' operating costs by removing the taxes in the case of gasoline and special fuels used by the farmers but in both cases only with respect to the use on a farm for farming purposes.

Your committee hopes that the Internal Revenue Service will coordinate the administration of the gasoline tax refund, to the extent feasible, with the administration of gasoline tax refunds by the various States.

II. SUMMARY OF PROVISIONS OF THE BILL

Section 1, the basic section in both the House and your committee's bill, provides for the refund of tax with respect to gasoline used on farms.

A. Gasoline

In the new code section 6420, it is provided that refunds are to be paid to purchasers of gasoline used on a farm for farming purposes. The refund under present tax rates will be 2 cents (1½ cents on and after April 1, 1956, if the reduced rates go into effect), multiplied by the number of gallons of gasoline used for the prescribed purposes.

The phrase "used on a farm for farming purposes" is defined as including only gasoline used—

(1) in carrying on a trade or business,
(2) on a farm in the United States, and
(3) for farming purposes.

The terms "farm" and "farming purposes" as used here are also defined terms. These definitions are described subsequently.

B. Time and Manner of Making Refund

The refunds with respect to gasoline are to be provided on an annual period ending on June 30. The claim is to be filed on or before September 30 of each year, and is to be filed by the farmer directly with the appropriate office of the Internal Revenue Service.

C. Definition of Farm and Farming Purpose

As indicated previously, refunds are to be available with respect to gasoline only where used in carrying on a trade or business, on a farm in the United States, and for farming purposes. The term "farm" as used here is defined as including stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards. This definition is the same as that presently in the 1954 Code with respect to the Federal Insurance Contributions Act which it is understood includes a feed yard for fattening cattle.

The term "farming purposes" is also defined in the House and your committee's bill. Under the House-passed bill it included use by any person in connection with cultivation of the soil, or the raising or harvesting of agricultural or horticultural commodities, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife. As a result, gasoline used by custom operators or other independent contractors performing a service on a farm in connection with cultivating the soil or raising or harvesting agricultural or horticultural commodities was eligible for a refund claim under the House-passed bill. Under your committee's bill, the term "farming purposes" includes the above-described type of operations, but generally only with respect to the operations of an owner, tenant, or operator on his own farm. Operations of a farmer other than on his own farm are included only where the gasoline so used is less than one-half of all of the gasoline used by the farmer for the prescribed type of operations.

The term "farming purposes" under both versions of the bill also includes the handling, drying, packing, grading, or storing of agricultural or horticultural commodities but only if the work is done by the owner, tenant, or operator and only if such person produced more than half of the commodity receiving this treatment during the year. This means that with respect to handling, drying, packing, grading, or storing of these commodities services performed by custom operators or other independent contractors, even though on the farm, are not the type with respect to which a refund may be claimed.

The definition of "farming purposes" under both the House and your committee's bill also includes the planting, cultivating, caring for, or cutting of trees, as well as the preparation (other than sawing logs into lumber, chipping and other milling operations) of trees for the market if the work is performed by

the owner, tenant, or operator of a farm and also only if it is incidental to farming operations. Still another category of work included in the farming purpose definition under both versions of the bill is that done by the owner, tenant, or operator of the farm in connection with the operation, management, conservation, improvement, or maintenance of the farm, including farm buildings, tools, and equipment.

D. Diesel Fuel and Special Motor Fuels

Section 2 of both versions of the bill provides relief for diesel fuel and special motor fuels (such as propane, butane, and so forth, including what is sometimes referred to as hot tractor fuel). In the case of diesel fuel, present law already provides that this tax is to apply only when the fuel is used in highway vehicles. Both the House and your committee's bill provide an exemption with respect to diesel fuel used in any of these highway vehicles where the vehicles are used on a farm for farming purposes.

In the case of special motor fuels, present law provides a tax only when the fuel is for use in a motor vehicle, motor boat, or airplane. Both versions of the bill provide an exemption for such use of special motor fuel when it is used on a farm for farming purposes.

Even under present law diesel fuel and special motor fuel are exempt from tax when used in a farm tractor since farm tractors have been held not to be motor vehicles under existing law.

Provision is also made in the House and your committee's bill for credits or refunds with respect to diesel fuel and special motor fuels which are used on a farm for farming purposes and have been sold taxpaid. In this case the credit or refund is to be obtained by processing the claim back through the person making the first taxpaid sale. This is the same procedure already in use in the case of other refunds or credits for diesel fuel and special motor fuel.

E. Civil Penalty for Excessive Claims

Section 3 of both the House and your committee's bill provides a special civil penalty for excessive claims for refunds with respect to gasoline. The new provision (in addition to any of the regular criminal penalties which may be applicable) provides that if a claim for a gasoline refund is excessive, a civil penalty may be imposed unless it can be shown that the claim for the excessive amount is due to reasonable cause. Section 3 is intended to be in addition to, and not in lieu of, other methods of enforcement now provided by existing law. The penalty imposed by section 3 is 2 times the excess amount claimed but not less than $10. As is indicated in section 4 in both versions of the bill the penalty described above, as well as the excessive amount itself, is to be assessed and collected as a tax.

III. TECHNICAL EXPLANATION OF THE BILL

Section 1 of the bill, both as passed by the House and as amended by your committee, amends subchapter B of chapter 65 of the Internal Revenue Code of 1954 by renumbering section 6420 as section 6421 and inserting a new section 6420. Section 1 of the bill, as amended by your committee, differs from the House bill only in the change noted below in subsection (b)(3)(A) of the proposed section 6420.

SECTION 6420. RELIEF FROM THE EXCISE TAX ON GASOLINE

Subsection (a).—Subsection (a) of the new section 6420 provides that the Secretary or his delegate shall pay to the ultimate purchaser of gasoline used on a farm for farming purposes the amount determined by multiplying (1) the number of gallons so used, by (2) the rate of tax on gasoline under section 4081 which applied on the date he purchased such gasoline. The meaning of the terms used on a farm for farming purposes, farm, farming purposes, and gasoline, are set forth in subsection (c) of section 6420. Interest is not allowable with respect to payments made pursuant to the provisions of section 6420. It will not be necessary for the claimant to show that the tax was in fact paid by the producer of the gasoline. In case of a change in rate of tax, the gasoline which is first purchased by the claimant will, as a general rule, be deemed to have been first used for purposes of claiming the farm-use payment.

Subsection (a) of section 6420 also provides that only the ultimate purchaser shall receive the payment for the farm use of gasoline. This makes it clear that prior purchasers of such gasoline will not be entitled to claim payment. For example, if farmer A purchases 200 gallons of gasoline and subsequently sells 50 gallons of such gasoline to farmer B who uses the fuel on his farm for farming purposes, only farmer B may claim payment with respect to the 50 gallons of gasoline so used by him inasmuch as he is the ultimate purchaser. The payment for farm use is to be made to the purchaser of the gasoline even though he is not the user of the gasoline. For instance, in the absence of special circumstances, a lessor of a farm who purchased the gasoline and furnished it to his tenant for use on the farm for farming purposes is the one who is authorized under the new section to claim payment if the gasoline is so used.

If a vehicle or equipment is used both on a farm and off the farm, or if it is used on a farm both for farming and nonfarming purposes, the claimant is entitled to payment under section 6420 only with respect to that portion of the gasoline which was consumed on the farm for farming purposes. Accordingly, if a truck used on a farm in connection with the cultivating or harvesting of agricultural commodities is also used on the highways (whether to deliver commodities to market or otherwise), the gasoline used in operating the truck on the highways is not to be taken into account in computing the payments authorized by section 6420.

Subsection (b).—Subsection (b) relates to the time for filing a claim and the period to be covered by such claim. Not more than one claim may be filed under this section by any person with respect to gasoline used during the 1-year period ending on June 30 of any year. This subsection also provides that no claim is to be allowed with respect to any 1-year period unless the claim is filed on or before September 30 of the calendar year in which the 1-year period ends. Thus, for example, for the 1-year period ending June 30, 1957, the purchaser may make a claim for any gasoline used (on a farm for farming purposes) after June 30, 1956, and before July 1, 1957. Such claim must be filed on or before September 30, 1957. It should be noted that under subsection (g) of the new section 6420, claims filed under this section before October 1, 1956, will cover only gasoline purchased after December 31, 1955. The same limitation will apply in the case of claims for any subsequent period, that is to say, no payment is allowable under this section at any time for gasoline purchased before January 1, 1956.

Subsection (c).—Paragraph (1) of subsection (c) of the new section 6420 provides that gasoline shall be treated as used on a farm for farming purposes only if used (1) in carrying on a trade or business, (2) on a farm situated in the United States (that is, the several States, Alaska, Hawaii, and the District of Columbia), and (3) for farming purposes. The term "trade or business" has the same meaning as when used in section 162 of the 1954 Code in connection with expenses paid or incurred in carrying on any trade or business.

Paragraph (2) of subsection (c) defines the term "farm" to include stock (including feed yards for fattening cattle), dairy, poultry, fruit, fur-bearing animals, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards. This definition is the same as that contained in section 3121(g) of the 1954 Code.

Under paragraph (3) of subsection (c) gasoline is to be treated as used for farming purposes only if used as provided in subparagraph (A), (B), (C), or (D). Under subparagraph (A) as it appears in the House bill, gasoline is treated as used for farming purposes if used by any person in connection with cultivating the soil, or in connection with raising or harvesting any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife.

Your committee has amended subparagraph (A) so that gasoline will be treated as used on a farm for farming purposes only if used by the owner, tenant, or operator of a farm in connection with cultivating the soil, or in connection with raising or harvesting any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife—

(*a*) on a farm of which he is the owner, tenant, or operator, or

(*b*) on any other farm, but only if the gasoline used by him on other farms is less than one-half of all gasoline used by him on all farms for the purposes enumerated in such subparagraph during the period with respect to which claim is filed.

Thus gasoline used by a custom operator or other independent contractor in performing a service for the purposes enumerated in subparagraph (A) may not be included in a refund claim by such operator. If a farmer provides services for another farmer (for the purposes enumerated in subparagraph (A)), all the gasoline used for such services may be included in his refund claim if less than one-half of all the gasoline used by him for the purposes enumerated in subparagraph (A) is used off his farm. If one-half or more of the gasoline is used by the farmer off his farm he may only claim a refund with respect to the gasoline used on his farm for those purposes.

Under both the House and your commitee's bill gasoline used on a farm in connection with the production or harvesting of maple sap or in connection with the production or harvesting of crude gum (oleoresin) from a living tree is treated as used for farming purposes; but gasoline used in the processing (as distinguished from the gathering) of maple sap into maple sirup or maple sugar or used in the processing of crude gum (oleoresin) into gum spirits of turpentine and gum rosin is not so treated, even though such processing operations are conducted on a farm.

Under subparagraph (B) of the new section 6420(c)(2) gasoline is to be treated as used for farming purposes, if used by the owner, tenant, or operator of a farm in handling, drying, packing, grading, or storing any agricultural or horticultural commodity in its unmanufactured state; but only if such owner, tenant, or operator produced more than one-half of the commodity which he so treated during the 1-year period with respect to which claim is filed under this section. The term "operator of a farm" means a person in possession of a farm and engaged in the operation of such farm. Whether use by the owner or tenant qualifies under this subparagraph (or subparagraph (C) or (D)) is to be determined without regard to whether the owner or tenant is in possession of the farm and without regard to whether he is the operator of the farm. Gasoline used in operations other than those of the prescribed character (such as canning, freezing, packaging, and processing operations) is not considered to be used for farming purposes within the meaning of subparagraph (B). The term "commodity" refers to a single agricultural or horticultural product, that is, all apples are to be treated as a single commodity, while apples and peaches are to be treated as two separate commodities. The operations with respect to each such commodity are to be considered separately in applying the "one-half" test described in the first sentence of this paragraph.

Under subparagraph (C), gasoline is to be treated as used for farming purposes if used by the owner, tenant, or operator of a farm, in connection with the planting, cultivating, caring for, or cutting of trees or in the preparation (other than milling) of trees for market; but only if such operations are incidental to farming operations. These operations include the felling of trees and cutting them into logs or firewood but do not include sawing logs into lumber, chipping, or other milling operations.

Operations of the character specified in subparagraph (C) must be incidental to the farming operations of such farm or to the farming operations of the owner, tenant, or operator of the farm. The word "incidental" is used in the statute in order to insure that the volume of the operations of the specified character will be, by comparison with the total farming operations involved, of a minor nature.

Under subparagraph (D), gasoline is to be treated as used for farming purposes if used by the owner, tenant, or operator of a farm in connection with the operation, management, conservation, improvement, or maintenance of such farm and its tools and equipment. These operations may include clearing land, repairing, painting, irrigating, and other activities which contribute in any way to the conduct of the farm, as such, as distinguished from any other enterprise in which the owner, tenant, or operator may be engaged. Since the gasoline must be used by the owner, tenant, or operator of the farm to which the operations relate, gasoline used in operations of the prescribed character by a commercial painting concern, for example, which contracts with a farmer to renovate his farm properties is not to be taken into account in computing claims under this section.

Under paragraph (4) of the subsection, the term "gasoline" is given the same meaning as when used in section 4082 (b). That is to say, the term means all products commonly or commercially known or sold as gasoline (including casinghead and natural gasoline).

Subsection (d).—Subsection (d) provides two conditions which must be observed in determining the amount of any payment to be made under section 6420.

First, it prohibits payment of any amount with respect to any gasoline which the Secretary or his delegate determines was exempt from the tax imposed by section 4081 of the 1954 Code. Thus, gasoline purchased by a State tax-free by virtue of section 4224 of the 1954 Code and used on a State prison farm for a farming purpose cannot be included in determining any amount claimed under section 6420.

Secondly, it provides that any amount that would otherwise have been payable under section 6420 with respect to any gasoline shall be reduced by any other amount which the Secretary or his delegate determines is payable under section 6420 or is refundable under any other provision of the 1954 Code to any person with respect to such gasoline.

Subsection (e).—Paragraph (1) of subsection (e) provides that all provisions of law, including penalties, applicable in respect of the tax imposed by section 4081 shall, insofar as applicable and not inconsistent with section 6420, apply in respect of the payments provided for in section 6420 to the same extent as if such payments constituted refunds of overpayments of the tax so imposed. Under this provision (to mention some, but not all, of the provisions which will apply) sections 6514 (relating to credits or refunds after period of limitations), 6532 (relating to periods of limitation on suits), 7405 (relating to action for recovery of erroneous refunds), and 7422 (relating to civil actions for refunds by taxpayers) of the 1954 Code apply.

However, by reason of subsection (e)(3), the Secretary or his delegate may not exercise his discretionary power under section 7504 of the 1954 Code to disregard a fractional part of a dollar.

For the purpose of determining the correctness of any claim made under this section, or of any payment made pursuant to such claim, subsection (e)(2) makes applicable paragraphs (1), (2), and (3) of section 7602 of the 1954 Code, relating to the examination of books and witnesses, as if the claimant were the person liable for tax.

Subsection (f).—Subsection (f) provides that the Secretary or his delegate may by regulations prescribe the conditions, not inconsistent with the provisions of section 6420, under which payments may be made under section 6420. Some of the conditions that might be appropriately prescribed by regulations are, for example:

(1) The type of records that the farmer will be required to keep;
(2) The form on which the claim must be filed;
(3) The information to be contained in such claim; and
(4) The evidence necessary to support such claim.

Subsection (g).—Subsection (g) provides that payments under section 6420 may be made only with respect to gasoline purchased by the ultimate purchaser after December 31, 1955. Thus, gasoline which was purchased by a farmer before January 1, 1956, but which he used on or after such date, may not be included in any claim under this section.

Subsection (h).—Subsection (h) provides appropriate cross references to other provisions of the 1954 Code.

SECTION 2. RELIEF FROM TAXES ON DIESEL FUEL AND SPECIAL MOTOR FUEL

Section 2 of both versions of the bill provides for an exemption from (or a credit or refund with respect to) the exise taxes on diesel fuel and special motor fuels, in cases involving the use of such liquids on a farm for farming purposes. Your committee made no changes in the House version of this section.

Subsection (a).—Paragraph (1) adds a new subsection (d) to section 4041 of the 1954 Code. Paragraph (1) of the new subsection (d) provides that no tax shall apply to diesel fuel or special motor fuel sold for use on a farm for farming purposes and that no tax shall apply to the use of such fuels on a farm for farming purposes. Under paragraph (2) of the new subsection (d), the test of whether diesel fuel or any special motor fuel is used on a farm for farming purposes is the same as the test set forth with respect to gasoline in section 6420(c). Paragraph (2) of section 2(a) of the bill provides that the amendment made by paragraph (1) of section 2(a) of the bill shall take effect on the day after the date of enactment of the bill.

Subsection (b).—Subsection (b) of section 2 of the bill makes a corresponding amendment to section 6416(b)(2)(C) of the 1954 Code to provide (in addition to the other situations in which a credit or refund may be claimed) that credit or refund shall be made if such diesel fuel or special motor fuel was (within the meaning of paragraphs (1), (2), and (3) of section 6420(c)) used on a farm for farming purposes. This amendment will apply with respect to liquids sold after December 31, 1955.

SECTION 3. CIVIL PENALTY

Section 3 of both versions of the bill adds a new section 6675 to the 1954 Code which provides an assessable penalty for claiming an excessive amount under section 6420. Under section 6675 a person making a claim under section 6420 for an excessive amount is liable, unless it is shown that the claim for such excessive amount is due to reasonable cause, to a penalty equal to 2 times the excessive amount of $10, whichever is greater. This penalty is in addition to any criminal penalty provided by law. Your committee made no changes in this section.

SECTION 4. TECHNICAL AMENDMENTS

Subsections (a), (b), (2), (c), (d), (e), (f), and (g) of section 4 of the bill make conforming changes in tables of sections and add appropriate cross references.

Subsection (b)(1) of section 4 of the bill adds a new section 6206 to the 1954 Code. Section 6206 provides that any portion of a payment made under section 6420 which constitutes an excessive amount (as defined in section 6675(b)), and any civil penalty provided by section 6675, may be assessed and collected as if it were a tax imposed by section 4081 and as if the person who made the claim were liable for such tax. Section 6206 also provides that the period for assessing the excessive amount, and for assessing the penalty, shall be 3 years from the last day prescribed for the filing of the claim under section 6420 (that is, 3 years from September 30).

Subsection (h) and (i) of section 4 of the bill amend the provisions relating to service and enforcement of a summons to bring into the scope of such provisions a summons issued under the authority of subsection (e)(2) of section 6420. Your committee had made a clerical amendment to subsection (i) to correct a reference to section 6420 (e) (2).

[H. R. 8780—P. L. 466]

RELIEF FROM TAXES ON GASOLINE AND SPECIAL FUELS USED ON FARMS

[House of Representatives Report No. 1957, Eighty-fourth Congress, Second Session]

[March 27, 1956]

Mr. Cooper, from the committee of conference, submitted the following conference report [To accompany H. R. 8780]:

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H. R. 8780) to amend the Internal Revenue Code of 1954 to relieve farmers from excise taxes in the case of gasoline and special fuels used on the farm for farming purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the House recede from its disagreement to the amendments of the Senate numbered 2 and 3 and agree to the same.

Amendment numbered 1:

That the House recede from its disagreement to the amendment of the Senate numbered 1, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

> "(A) *by the owner, tenant, or operator of a farm, in connection with cultivating the soil, or in connection with raising or harvesting any agricultural*

or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife, on a farm of which he is the owner, tenant, or operator; except that if such use is by any person other than the owner, tenant, or operator of such farm, then (i) for purposes of this subparagraph, in applying subsection (a) to this subparagraph, and for purposes of section 6416(b)(2)(C)(ii) (but not for purposes of section 4041), the owner, tenant, or operator of the farm on which gasoline or a liquid taxable under section 4041 is used shall be treated as the user and ultimate purchaser of such gasoline or liquid, and (ii) for purposes of applying section 6416 (b) (2) (C) (ii), any tax paid under section 4041 in respect of a liquid used on a farm for farming purposes (within the meaning of this subparagraph) shall be treated as having been paid by the owner, tenant, or operator of the farm on which such liquid is used;

And the Senate agree to the same.

JERE COOPER,
W. D. MILLS,
NOBLE J. GREGORY,
DANIEL A. REED,
By T. A. JENKINS,
THOMAS A. JENKINS,
Managers on the Part of the House.

HARRY F. BYRD,
WALTER F. GEORGE,
By HARRY F. BYRD,
ROBT. KERR,
EDWARD MARTIN,
FRANK CARLSON,
Managers on the Part of the Senate.

STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H. R. 8780) to amend the Internal Revenue Code of 1954 to relieve farmers from excise taxes in the case of gasoline and special fuels used on the farm for farming purposes, submit the following statement in explanation of the effect of the action agreed upon by the conferees and recommended in the accompanying conference report:

Amendment No. 1: Subparagraphs (A), (B), (C), and (D) of section 6420(c)(3) of the Internal Revenue Code of 1954 as proposed to be amended by the bill as it passed both the House and Senate, prescribe the uses of gasoline which for purposes of the bill are to be treated as use for farming purposes. Senate amendment No. 1 struck out subparagraph (A) and inserted a substitute. No change was made in subparagraph (B), (C), or (D).

Under subparagraph (A) of the House bill, gasoline was to be treated as used for farming purposes if used by "any person" in connection with cultivating the soil, or in connection with raising or harvesting any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife.

Under Senate amendment No. 1, gasoline used for any of the purposes set forth in the preceding paragraph was to be treated as used for farming purposes only if used by the owner, tenant, or operator of a farm (1) on a farm of which he is the owner, tenant, or operator, or (2) on any other farm (but only if the gasoline used by him on other farms is less than one-half of all gasoline used by him, during the period with respect to which claim is filed, on all farms for the purposes set forth in the preceding paragraph). Thus, under the Senate amendment gasoline used by a custom operator or other independent contractor in performing a service for one of the purposes specified in section 6420 (c) (3) (A) was not to be included in any refund claim.

Under the conference agreement, as under the House bill and the Senate amendment, if gasoline is used on a farm by the owner, tenant, or operator thereof for the purposes set forth above, he will be entitled to the payment provided for under the new section 6420 if he is the ultimate purchaser of such gasoline. In addition, under the conference agreement, if gasoline is used on

a farm by any other person for these purposes, the owner, tenant, or operator of such farm is treated as the user and ultimate purchaser of the gasoline, and is therefore entitled to the payment. For example, where a custom operator uses the gasoline, the owner, tenant, or operator of the farm on which the gasoline is used will be entitled to the payment. In general, in the case where a custom operator performs services described in the new section 6420(c)(3)(A) on a farm, the payment under section 6420(a) will be made to the person (the owner, tenant, or operator, as the case may be) for whom such services are performed.

Under the conference agreement, comparable rules are provided with respect to diesel fuel and special motor fuels. For example, if a custom operator performs services described in the new section 6420(c)(3)(A) and uses a special fuel in a motor vehicle, the tax imposed by section 4041(b) would apply but the owner, tenant, or operator of the farm on which the fuel is used will be entitled to a refund of the tax paid with respect to the fuel used on the farm. As in the case of gasoline, the refund will, in general, be made to the person (the owner, tenant, or operator, as the case may be) for whom the custom operator performed the services.

Amendments Nos. 2 and 3: These amendments are clerical. The House recedes.

JERE COOPER,
W. D. MILLS,
NOBLE J. GREGORY,
DANIEL REED,
By T. A. JENKINS,
THOMAS A. JENKINS,
Managers on the Part of the House.

[H. R. 9166—P. L. 458]

TAX RATE EXTENSION ACT OF 1956

[House of Representatives Report No 1860, Eighty-fourth Congress, Second Session]

[March 8, 1956]

Mr. Cooper, from the Committee on Ways and Means, submitted the following report [To accompany H. R. 9166]:

The Committee on Ways and Means, to whom was referred the bill (H. R. 9166) to provide a 1-year extension of the existing corporate normal-tax rate and of certain excise-tax rates, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. GENERAL STATEMENT

H. R. 9166, reported unanimously by your committee, provides for a 1-year extension of the present corporate income tax rate and the existing rates of certain excises. The rates of these taxes otherwise are scheduled for reduction on April 1, 1956.

The present 52 percent corporate income tax rate, without the 1-year extension provided in the bill, would revert to 47 percent as of the first of this April through a reduction in the normal tax rate from 30 to 25 percent. The excise-tax rates, which without this bill also would be decreased this April, are those on alcoholic beverages, cigarettes, gasoline, automobiles, trucks and buses, automobile parts and accessories, and diesel and special motor fuel.

Your committee has agreed to the extensions of the present corporate and excise tax rates because of their effect on the Federal budget in the fiscal years 1956 and 1957. If these rates are not extended there would be no surplus in the fiscal year 1956 and there would be a deficit of nearly $2 billion in the fiscal year 1957. This is shown in greater detail in the following section of this report.

The President in his budget message made the following statement:

To reach a balanced budget in the fiscal year 1956 and in the fiscal year 1957 it will be necessary in addition to continuing everyday efforts to keep spending

under control, to continue all the present excise taxes without any reduction and the corporation income taxes at their present rates for another year beyond April 1, 1956.

II. REVENUE AND BUDGET EFFECTS

The revenue effects of your committee's bill for the fiscal years 1956 and 1957, and also on a full year's basis, are shown in table 1. Only the extension of the excise taxes is expected to have any effect on budget receipts in the fiscal year 1956. Under existing law the excise tax reductions would be effective for April, May, and June in the fiscal year 1956, and the collections for the fiscal year 1956 would reflect most of the reductions for these months. This decrease in revenue is avoided under the bill.

The reduction in corporate taxes under existing law will not be reflected in receipts in fiscal year 1956 because of the lag in corporate tax collections. Most of the revenue effect from extending the present corporate income tax rate for 1 year beyond April 1, 1956, will be reflected in collections for the fiscal year 1957, but some effect will carry over into the fiscal year 1958.

If the various excise tax rates provided for in this bill were not extended until April 1, 1957, refunds of approximately $200 million would have to be paid to dealers with respect to their floor stocks, or inventories of taxed articles, on which the rates would be reduced. For the most part these refunds would have been paid in the fiscal year 1957 if these excise tax rates are not extended. With the 1-year extension provided in this bill, expenditures for these floor-stock refunds will for the most part be postponed until the fiscal year 1958.

TABLE 1.—*Estimated revenue gain from extension of existing corporate and excise tax rates*

[Extension from Apr. 1, 1956, to Apr. 1, 1957]

	Change in rate which would occur without bill	Estimated revenue gain (in millions of dollars)		
		Fiscal 1956	Fiscal 1957	Full-year effect
Corporation income tax	52 to 47 percent (normal tax reduced from 30 to 25 percent).	----	1,180	2,020
Excises:				
Alcohol taxes:				
Distilled spirits	$10.50 to $9 per gallon	38	90	128
Beer	$9 to $8 per barrel	21	64	85
Wine	Various rates	3	6	9
Total, alcoholic beverages		62	160	222
Tobacco taxes: Cigarettes (small)	$4 to $3.50 per 1,000	49	145	194
Manufacturers' excise taxes:				
Gasoline	2 to 1½ cents per gallon	31	219	250
Passenger cars	10 to 7 percent	47	328	375
Trucks, buses, and trailers	8 to 5 percent	8	58	66
Auto parts and accessories	8 to 5 percent	6	46	52
Total, manufacturers' excises		92	651	743
Retail taxes: Diesel and special motor fuels	2 to 1½ cents per gallon	1	6	7
Total excises		204	962	1,166
Total, corporate income tax and excises		204	2,142	3,186

NOTE.—Floor stock refunds of about $200 million will be postponed by the extension of existing excise tax rates.

Source: Prepared by the staff of the Joint Committee on Internal Revenue Taxation.

On a full year's basis the extension of the present corporate rate will increase revenues by $2,020 million and the excise taxes by $1,166 making a total full-year effect under the bill of $3,186 million.

Table 2 shows the effect of your committee's bill on the budgets for the fiscal years 1956 and 1957. Expenditures in the budget as presented by the President

for the fiscal years 1956 and 1957 are estimated at $64.3 billion and $65.9 billion, respectively. Receipts for these years are estimated at $64.5 billion and $66.3 billion, respectively. These figures reflect a surplus of $200 million in 1956 and $400 million in 1957. As was indicated in table 1, if the present corporate income and excise tax rates were not extended there would be a loss in revenue of $204 million in the fiscal year 1956 and $2,142 million in the fiscal year 1957. Moreover, if these rates were not extended floor-stock refunds of about $200 million also would have to be paid during the fiscal year 1957. Thus, the failure to extend these rates would remove budgetary surplus in the fiscal year 1956 and result in a deficit of nearly $2 billion in the fiscal year 1957.

TABLE 2.—*Effect on the 1956 and 1957 budgets of allowing terminations of rates as scheduled Apr. 1, 1956*

	Fiscal year	
	1956	1957
Budget expenditures	$64.3	$65.9
Budget receipts	64.5	66.3
Budget surplus (+)	+.2	+.4
Effect of termination of corporate and excise tax rates:		
Decrease (−) in tax collections	−.2	−2.1
Payment of floor stock refunds		−.2
Budget surplus (+) or deficit (−) without extension of rates	0	−1.9

Source: Prepared by the staff of the Joint Committee on Internal Revenue Taxation.

III. SUMMARY OF BILL

The first section of the bill indicates that this act is to be cited as the "Tax Rate Extension Act of 1956."

Section 2 of the bill extends for 1 year the present 52 percent corporate income tax rate which otherwise is due to revert to 47 percent as of April 1, 1956. The 5 percentage point reduction will occur in the 30 percent normal tax to which all corporate taxable income is subject. The 22 percent surtax, which applies only to income above $25,000, remains unchanged.

The rate extension provided by section 2 in the case of the corporate income tax makes the 52 percent rate applicable to taxable years beginning before April 1, 1957, and a 47 percent rate applicable with respect to taxable years beginning on or after this date. A proration formula, already in section 21 of the Internal Revenue Code, provides for corporations whose taxable years overlap April 1, 1957.

Section 2 extends the present corporate income tax rate not only for ordinary corporations but also for mutual insurance companies and interinsurers.

Section 3 of the bill extends for 1 year the present excise tax rates due to be automatically reduced as of April 1, 1956. These include the excise taxes on distilled spirits, beer, wine, cigarettes, gasoline, automobiles, trucks and buses, automobile parts and accessories, and diesel and special motor fuel. These excises are described more fully in table 3 which shows the unit of tax and the rates before and after April 1, 1957, under this bill.

In addition to extending the rates specified above, section 3 of the bill postpones for 1 more year the floor-stock refunds or credits presently effective with respect to stocks of various tax-paid products on hand on April 1, 1956. These floor-stock refunds are available in the case of distilled spirits, wines and beer, cigarettes, gasoline, and automobiles, trucks, and buses, and automobile parts and accessories.

Section 3 also extends for 1 year the present drawback of $9.50 per proof gallon for distilled spirits used in the manufacture of medicines, medicinal preparations, food products, flavors, or flavoring extracts, which are unfit for beverage purposes. In conformance with the change in the distilled spirits tax, as of April 1, 1957, this drawback under the bill decreases to $8 per proof gallon in order to maintain a net tax of $1 per proof gallon on distilled spirits used for these purposes.

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TABLE 3.—*Excise tax rates extended until Apr. 1, 1957* [1]

	Unit of tax	Rate extended for period from Apr. 1, 1956, to Mar. 31, 1957	Rate to become effective Apr. 1, 1957 [1]
Liquor taxes:			
Distilled spirits	Per proof gallon	$10.50	$9.
Beer	Per barrel	$9	$8.
Wine:			
Still wine:			
Containing less than 14 percent alcohol.	Per wine gallon	17 cents	15 cents.
Containing 14 to 21 percent alcohol	Per wine gallon	67 cents	60 cents.
Containing 21 to 24 percent alcohol	Per wine gallon	$2.25	$2.
Containing more than 24 percent alcohol.	Per wine gallon	$10.50	$9.
Sparkling wines, liqueurs, cordials, etc.:			
Champagne or sparkling wine	Per wine gallon	$3.40	$3.
Liqueurs, cordials, etc	Per wine gallon	$1.92	$1.60.
Artificially carbonated wines	Per wine gallon	$2.40	$2.
Tobacco taxes: Cigarettes	Per 1,000	$4	$3.50.
Manufacturer's excises:			
Gasoline	Per gallon	2 cents	1½ cents.
Passenger cars	Manufacturers' sale price	10 percent	7 percent.
Trucks, buses, truck trailers	Manufacturers' sale price	8 percent	5 percent.
Auto parts and accessories	Manufacturers' sale price	8 percent	5 percent.
Retailers' excises: Diesel and special motor fuel	Per gallon	2 cents	1½ cents.
Total excises			

[1] These rates were increased by the Revenue Act of 1951 and the increases were scheduled to terminate on Apr. 1, 1954. The Excise Tax Reduction Act of 1954 extended these rate increases to Apr. 1, 1955, and the Tax Rate Extension Act of 1955 extended these rate increases to Apr. 1, 1956.

Source: Prepared by the staff of the Joint Committee on Internal Revenue Taxation.

[H. R. 9166—P. L. 458]

TAX RATE EXTENSION ACT OF 1956

[Senate Report No. 1710, Eighty-fourth Congress, Second Session, Calendar No. 1735]

[March 23 (legislative day, March 19), 1956]

Mr. Byrd, from the Committee on Finance, submitted the following report [to accompany H. R. 9166]:

The Committee on Finance, to whom was referred the bill (H. R. 9166) to provide a 1-year extension of the existing corporate normal-tax rate and of certain excise-tax rates, having considered the same, report favorably thereon without amendment and recommended that the bill do pass.

I. GENERAL STATEMENT

H. R. 9166, reported unanimously by your committee without amendment, provides for a 1-year extension of the present corporate income tax rate and the existing rates of certain excises. The rates of these taxes otherwise are scheduled for reduction on April 1, 1956.

The present 52 percent corporate income tax rate, without the 1-year extension provided in the bill, would revert to 47 percent as of the first of this April as the result of a reduction in the normal tax rate from 30 to 25 percent. The excise-tax rates, which without this bill also would be decreased this April, are those on alcoholic beverages, cigarettes, gasoline, automobiles, trucks and buses, automobile parts and accessories, and diesel and special motor fuel.

Your committee agrees with the House that the extensions of the present corporate and excise tax rates are desirable because of their effect on the Federal budget in the fiscal years 1956 and 1957. If these rates are not extended there would be no surplus in the fiscal year 1956 and there would be a deficit of nearly $2 billion in the fiscal year 1957. This is shown in greater detail in the following section of this report.

The President in his budget message made the following statement:

To reach a balanced budget in the fiscal year 1956 and in the fiscal year 1957 it will be necessary in addition to continuing everyday efforts to keep spending under control, to continue all the present excise taxes without any reduction and the corporation income taxes at their present rates for another year beyond April 1, 1956.

II. REVENUE AND BUDGET EFFECTS

The revenue effects of the House and your committee's bill for the fiscal years 1956 and 1957, and also on a full year's basis, are shown in table 1. Only the extension of the excise taxes is expected to have any effect on budget receipts in the fiscal year 1956. Under existing law the excise tax reductions would be effective for April, May, and June in the fiscal year 1956, and the collections for the fiscal year 1956 would reflect most of the reductions for these months. This decrease in revenue is avoided under the bill.

The reduction in corporate taxes under existing law will not be reflected in receipts in fiscal year 1956 because of the lag in corporate tax collections. Most of the revenue effect from extending the present corporate income tax rate for 1 year beyond April 1, 1956, will be reflected in collections for the fiscal year 1957, but some effect will carry over into the fiscal year 1958.

If the various excise tax rates provided for in this bill were not extended until April 1, 1957, refunds of approximately $200 million would have to be paid to dealers with respect to their floor stocks, or inventories of taxed articles, on which the rates would be reduced. For the most part these refunds would have been paid in the fiscal year year 1957 if these excise tax rates are not extended. With the 1-year extension provided in this bill, expenditures for these floor-stock refunds will for the most part be postponed until the fiscal year 1958.

TABLE 1.—*Estimated revenue gain from extension of existing corporate and excise tax rates*

[Extension from Apr. 1, 1956, to Apr. 1, 1957]

	Change in rate which would occur without bill	Estimated revenue gain (in millions of dollars)		
		Fiscal 1956	Fiscal 1957	Full-year effect
Corporation income tax	52 to 47 percent (normal tax reduced from 30 to 25 percent).	.....	1,180	2,020
Excises:				
Alcohol taxes:				
Distilled spirits	$10.50 to $9 per gallon	38	90	128
Beer	$9 to $8 per barrel	21	64	85
Wine	Various rates	3	6	9
Total, alcoholic beverages		62	160	222
Tobacco taxes: Cigarettes (small)	$4 to $3.50 per 1,000	49	145	194
Manufacturers' excise taxes:				
Gasoline	2 to 1½ cents per gallon	31	219	250
Passenger cars	10 to 7 percent	47	328	375
Trucks, buses, and trailers	8 to 5 percent	8	58	66
Auto parts and accessories	8 to 5 percent	6	46	52
Total, manufacturers' excises		92	651	743
Retail taxes: Diesel and special motor fuels	2 to 1½ cents per gallon	1	6	7
Total excises		204	962	1,166
Total, corporate income tax and excises		204	2,142	3,186

NOTE.—Floor stock refunds of about $200 million will be postponed by the extension of existing excise tax rates.

Source: Prepared by the staff of the Joint Committee on Internal Revenue Taxation.

On a full year's basis the extension of the present corporate rate will increase revenues by $2,020 million and the excise taxes by $1,166 million, making a total full-year effect under the bill of $3,186 million.

Table 2 shows the effect of the House and your committee's bill on the budgets for the fiscal years 1956 and 1957. Expenditures in the budget as presented by the President for the fiscal years 1956 and 1957 are estimated at $64.3 billion and $65.9 billion, respectively. Receipts for these years are estimated at $64.5 billion and $66.3 billion, respectively. These figures reflect a surplus of $200 million in 1956 and $400 million in 1957. As was indicated in table 1, if the present corporate income and excise tax rates were not extended there would be a loss in revenue of $204 million in the fiscal year 1956 and $2,142 million in the fiscal year 1957. Moreover, if these rates were not extended floor-stock refunds of about $200 million also would have to be paid during the fiscal year 1957. Thus, the failure to extend these rates would remove the budgetary surplus in the fiscal year 1956 and result in a deficit of nearly $2 billion in the fiscal year 1957.

TABLE 2.—*Effect on the 1956 and 1957 budgets of allowing terminations of rates as scheduled Apr. 1, 1956*

	Fiscal year	
	1956	1957
Budget expenditures	$64.3	$65.9
Budget receipts	64.5	66.3
Budget surplus (+)	+.2	+.4
Effect of termination of corporate and excise tax rates:		
Decrease (−) in tax collections	−.2	−2.1
Payment of floor stock refunds		−.2
Budget surplus (+) or deficit (−) without extension of rates	0	−1.9

Source: Prepared by the staff of the Joint Committee on Internal Revenue Taxation.

III. SUMMARY OF BILL

The first section of the bill indicates that this act is to be cited as the "Tax Rate Extension Act of 1956."

Section 2 of the bill extends for 1 year the present 52 percent corporate income tax rate which otherwise is due to revert to 47 percent as of April 1, 1956. The 5 percentage point reduction will occur in the 30 percent normal tax to which all corporate taxable income is subject. The 22 percent surtax, which applies only to income above $25,000 remains unchanged.

The rate extension provided by section 2 in the case of the corporate income tax makes the 52 percent rate applicable to taxable years beginning before April 1, 1957, and a 47 percent rate applicable with respect to taxable years beginning on or after this date. A proration formula, already in section 21 of the Internal Revenue Code, provides for corporations whose taxable years overlap April 1, 1957.

Section 2 extends the present corporate income tax rate not only for ordinary corporations but also for mutual insurance companies and interinsurers.

Section 3 of the bill extends for 1 year the present excise tax rates due to be automatically reduced as of April 1, 1956. These include the excise taxes on distilled spirits, beer, wine, cigarettes, gasoline, automobiles, trucks and buses, automobile parts and accessories, and diesel and special motor fuel. These excises are described more fully in table 3 which shows the unit of tax and the rates before and after April 1, 1957, under this bill.

In addition to extending the rates specified above, section 3 of the bill postpones for 1 more year the floor-stock refunds or credits presently effective with respect to stocks of various tax-paid products on hand on April 1, 1956. These floor-stock refunds are available in the case of distilled spirits, wines and beer, cigarettes, gasoline, and automobiles, trucks, and buses, and automobile parts and accessories.

Section 3 also extends for 1 year the present drawback of $9.50 per proof gallon for distilled spirits used in the manufacture of medicines, medicinal preparations, food products, flavors, or flavoring extracts, which are unfit for beverage purposes. In conformance with the change in the distilled spirits tax, as of April 1, 1957, this drawback under the bill decreases to $8 per proof gallon in order to maintain a net tax of $1 per proof gallon on distilled spirits used for these purposes.

TABLE 3.—*Excise tax rates extended until Apr. 1, 1957* [1]

	Unit of tax	Rate extended for period from Apr. 1, 1956, to Mar. 31, 1957	Rate to become effective Apr. 1, 1957 [1]
Liquor taxes:			
Distilled spirits	Per proof gallon	$10.50	$9.
Beer	Per barrel	$9	$8.
Wine:			
Still wine:			
Containing less than 14 percent alcohol.	Per wine gallon	17 cents	15 cents.
Containing 14 to 21 percent alcohol	Per wine gallon	67 cents	60 cents.
Containing 21 to 24 percent alcohol	Per wine gallon	$2.25	$2.
Containing more than 24 percent alcohol.	Per wine gallon	$10.50	$9.
Sparkling wines, liqueurs, cordials, etc.:			
Champagne or sparkling wine	Per wine gallon	$3.40	$3.
Liqueurs, cordials, etc	Per wine gallon	$1.92	$1.60.
Artificially carbonated wines	Per wine gallon	$2.40	$2.
Tobacco taxes: Cigarettes	Per 1,000	$4	$3.50.
Manufacturer's excises:			
Gasoline	Per gallon	2 cents	1½ cents.
Passenger cars	Manufacturers' sale price	10 percent	7 percent.
Trucks, buses, truck trailers	Manufacturers' sale price	8 percent	5 percent.
Auto parts and accessories	Manufacturers' sale price	8 percent	5 percent.
Retailers' excises: Diesel and special motor fuel	Per gallon	2 cents	1½ cents.

[1] These rates were increased by the Revenue Act of 1951 and the increases were scheduled to terminate on Apr. 1, 1954. The Excise Tax Reduction Act of 1954 extended these rate increases to Apr. 1, 1955, and the Tax Rate Extension Act of 1955 extended these rate increases to Apr. 1, 1956.

Source: Prepared by the staff of the Joint Committee on Internal Revenue Taxation.

PART V

ADMINISTRATIVE AND MISCELLANEOUS MATTERS

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PART V

ADMINISTRATIVE AND MISCELLANEOUS MATTERS

TREASURY DEPARTMENT INTERPRETATION OF SECTION 10.2 OF TREASURY DEPARTMENT CIRCULAR 230 (31 C. F. R. 10.2)

For some months the Treasury Department has had under consideration the revision of Treasury Department Circular 230, C. B. 1952–2, 275, relating to practice before the Department.

Congress has given the Treasury Department the responsibility of regulating practice before the Department. It is in the exercise of this responsibility that the Department has issued the rules and regulations set forth in Circular 230, taking into consideration, among other things, the need of taxpayers for tax advice and assistance, the number of tax returns filed each year, the volume and complexity of problems relating thereto, the skills and training required for proper representation of taxpayers' interests and the availability of people who can provide such service.

The Department believes the standards prescribed in Circular 230 have generally operated in a highly satisfactory manner, have made available to taxpayers representatives to assist them in presenting their interests to the Department, and have facilitated fair and orderly administration of the tax laws.

It is the intention of the Department that all persons enrolled to practice before it be permitted to fully represent their clients before the Department, in the manner hereinafter indicated. This is apparent from section 10.2(b), which states that the scope of practice (of agents as well as attorneys) before the Department comprehends "all matters connected with the presentation of a client's interest to the Treasury Department." Enrollees, whether agents or attorneys, have been satisfactorily fully representing clients before the Department for many years. The Department believes this has been beneficial to the taxpayers and to the Government and that there presently appears no reason why the present scope and type of practice should not continue as it has in the past.

The Department's attention has been called to the decisions of certain State courts and to statements which suggest varying interpretations of section 10.2(f) of the Circular. This subsection makes it clear that an enrolled agent shall have the same rights, powers, and privileges and be subject to the same duties as an enrolled attorney, except that an enrolled agent may not prepare and interpret certain written instruments. The second proviso of the subsection states that

nothing in the regulations is to be construed as authorizing persons not members of the bar to practice law. The uniform interpretation and administration of this and other sections of Circular 230 by the Department are essential to the proper discharge of the above responsibility imposed on it by the Congress.

It is not the intention of the Department that this second proviso should be interpreted as an election by the Department not to exercise fully its responsibility to determine the proper scope of practice by enrolled agents and attorneys before the Department. It should be equally clear that the Department does not have the responsibility nor the authority to regulate the professional activities of lawyers and accountants beyond the scope of their practice before the Department as defined in section 10.2(b) and nothing in Circular 230 is so intended.

The Department has properly placed on its enrolled agents and enrolled attorneys the responsibility of determining when the assistance of a member of the other profession is required. This follows from the provisions in section 10.2(z) that enrolled attorneys must observe the canons of ethics of the American Bar Association and enrolled agents must observe the ethical standards of the accounting profession. The Department has been gratified to note the extent to which the two professions over the years have made progress toward mutual understanding of the proper sphere of each, as for example in the Joint Statement of Principles Relating to Practice in the Field of Federal Income Taxation.

The question of Treasury practice will be kept under surveillance so that if at any time the Department finds that the professional responsibilities of its enrolled agents and enrolled attorneys are not being properly carried out or understood, or that enrolled agents and attorneys are not respecting the appropriate fields of each in accordance with that Joint Statement, it can review the matter to determine whether it is necessary to amend these provisions of the Circular or take other appropriate action.

G. M. HUMPHREY,
Secretary of the Treasury.

Dated January 30, 1956.

DEPARTMENT OF THE TREASURY
TREASURY DEPARTMENT ORDER NO. 107
(REVISION NO. 3)

Authorization for certain officers to affix the Seal of the Treasury Department in the authentication of books, records, documents, etc.

By virtue of the authority vested in me as Secretary of the Treasury, including the authority conferred by section 161 of the Revised Statutes, it is hereby ordered that:

1. Except as provided for in paragraph 2, the following officers are authorized to affix the Seal of the Treasury Department in the authentication of originals and copies of books, records, papers, writings, and documents of the Department, for all purposes, including the purposes authorized by 28 U. S. C. 1733(b):

(a) In the Office of Administrative Services:
  (1) Director of Administrative Services
  (2) Chief, Office Services Division
  (3) Records Administration Officer
  (4) Chief, Document Distribution Section
(b) In the Internal Revenue Service:
  (1) Commissioner of Internal Revenue
  (2) Director, and Assistant Director, Audit Division
  (3) Chief, and Assistant Chief, Audit Operations Branch, Audit Division
  (4) Chief, and Assistant Chief, Miscellaneous Services Section, Audit Operations Branch, Audit Division
(c) In the Bureau of Customs:
  (1) Commissioner of Customs
  (2) Assistant Commissioner of Customs
  (3) Deputy Commissioner, Division of Investigations
  (4) Deputy Commissioner, Division of Appraisement Administration
  (5) Deputy Commissioner, Division of Management and Controls

2. Copies of documents which are to be published in the Federal Register may be certified only by the officers named in paragraph 1(a) of this Order.

3. The Director of Administrative Services and the Commissioner of Internal Revenue Service are authorized to retain custody of the dies of the Treasury Seal now in their possession.

The officers authorized in paragraph No. 1(c) may make use of such dies.

DAVID W. KENDALL,
Acting Secretary of the Treasury.

November 30, 1955.

DEPARTMENT OF THE TREASURY
TREASURY DEPARTMENT ORDER NO. 150-41 [1]

Delegation of function of approving Internal Revenue Regulations.

By virtue of the authority vested in me by Reorganization Plan No. 26 of 1950, the Special Assistant to the Secretary in Charge of Tax Policy is authorized to approve such regulations prescribed by the Commissioner of Internal Revenue (or the Acting Commissioner of Internal Revenue) as are required to be approved by the Secretary of the Treasury or his delegate.

G. M. HUMPHREY,
Secretary of the Treasury.

Dated February 13, 1956.

[1] 21 F. R. 1111.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
COMMISSIONER'S REORGANIZATION ORDER NO. 15, AMENDMENT 1 [2]

General delegation of functions to Regional Commissioners and District Directors of Internal Revenue.

Pursuant to the authority vested in me as Commissioner of Internal Revenue, paragraph 5 of Commissioner's Reorganization Order No. 15, dated July 1, 1953,[3] is hereby amended to read:

5. *Designation to act as Regional Commissioner or District Director.*—Designations to act as Regional Commissioner or District Director shall be made as follows:

(a) *Regional Commissioner.*—The Regional Commissioner shall designate an Assistant Regional Commissioner as Acting Regional Commissioner to perform the functions of the Office of Regional Commissioner during any period of absence of the Regional Commissioner. Such designation shall not be applicable if the position of Regional Commissioner becomes vacant. In that event the Commissioner will designate the employee to serve as Acting Regional Commissioner.

(b) *District Director.*—In a District Office having an Assistant District Director, such Assistant shall become Acting District Director and perform the functions of the Office of District Director in case of the death, separation, or absence of the District Director, unless and until the Regional Commissioner designates another officer or employee to serve as Acting District Director. In a District Office where there is no Assistant District Director, (1) the Regional Commissioner shall designate the employee who shall become Acting District Director and perform the functions of the Office of District Director in case of the death or separation of the District Director, and (2) the District Director shall designate the employee who shall become Acting District Director and perform the functions of the Office of District Director in the absence of the District Director, unless and until the Regional Commissioner designates another officer or employee to serve as Acting District Director.

(c) *Recording.*—Designations as Acting Regional Commissioner and Acting District Director shall be made a matter of record.

(d) *Bonding.*—Any requirement for bond for the faithful performance of duty by the District Director shall apply to any officer or employee performing the functions of the District Director as herein provided. This amendment is effective December 1, 1953.

O. GORDON DELK,
Acting Commissioner.

November 23, 1953.

COMMISSIONER DELEGATION ORDER NO. 11 [4]

(Effective December 2, 1955)

(20 F. R. 9870)

Delegation of authority to accept certain offers in compromise.

Pursuant to authority vested in me by Treasury Department Order No. 150–25, dated June 1, 1953,[5] District Directors of Internal Revenue are hereby delegated authority to accept offers in compromise submitted under the provisions of section 3761 of the Internal Revenue

[2] 18 F. R. 7646.
[3] C. B. 1953–2, 505.
[4] Commissioner Delegation Order Nos. 9 and 10 were not published.
[5] 18 F. R. 3238.

Code of 1939, or section 7122 of the Internal Revenue Code of 1954, in cases in which the unpaid amount of the tax (including any interest, additional amount, addition to the tax, or assessable penalty) is less than $5,000, and in cases involving specific penalties, except that this delegation of authority is subject to the limitations contained in applicable regulations and procedures.

O. GORDON DELK,
Acting Commissioner.

COMMISSIONER DELEGATION ORDER NO. 12[6]

(Effective December 2, 1955)

Designation to act as Regional Commissioner and as District Director.

1. The Regional Commissioner shall designate an Assistant Regional Commissioner to serve as Acting Regional Commissioner during any period of absence of the Regional Commissioner. If, however, the position of Regional Commissioner becomes vacant, the Commissioner will designate the employee who will serve as Acting Regional Commissioner.

2. In a District Office having an Assistant District Director, such Assistant will become Acting District Director in case of the absence, separation or death of the District Director, unless or until the Regional Commissioner designates another officer to serve as Acting District Director. In a district where there is no Assistant District Director, (a) the Regional Commissioner will designate the employee who becomes Acting District Director in case of the separation or death of the District Director, and (b) the District Director will designate the employee who will serve as Acting District Director in the absence of the District Director, unless or until the Regional Commissioner designates another officer to serve as Acting District Director.

3. Designations as Acting Regional Commissioner and Acting District Director shall be made a matter of record.

4. This Order supersedes Commissioner's Reorganization Order No. 15, Amendment 1, dated November 23, 1953 (reproduced on the following page).

O. GORDON DELK,
Acting Commissioner.

COMMISSIONER DELEGATION ORDER NO. 14[7]

(Effective October 5, 1955)

(21 F. R. 502)

Granting extension of time for filing statements in accordance with section 534(c) of the Internal Revenue Code of 1954.

Each Regional Commissioner is hereby authorized to delegate to appropriate officials of the offices of District Directors and the Regional Appellate Division authority to grant taxpayers an extension

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[6] 20 F. R. 9870.
[7] Published in 21 F. R. 502; Commissioner Delegation Order No. 13 not published.

of time not in excess of thirty additional days for the purpose of filing the statement of grounds called for in registered mail notification sent pursuant to section 534, as amended by Public Law 367 [C. B. 1955–2, 768].

This order is effective retroactively to October 5, 1955, and supersedes telegraphic authorization of that date. Delegations heretofore made pursuant to the October 5, 1955, telegraphic authorization shall continue in force and effect until specifically revoked under proper authority.

O. GORDON DELK,
Acting Commissioner.

COMMISSIONER DELEGATION ORDER NO. 15 [8]

(Effective January 11, 1956)

Inspection of certain returns by Department of Health, Education, and Welfare

Pursuant to the authority contained in Treasury Decisions 6135 and 6136, approved June 20, 1955 [I. R. B. 1955–29, 6 and 22, respectively], District Directors of Internal Revenue are hereby authorized upon request, in accordance with prescribed procedures, to make available for inspection by any duly authorized officer or employee of the Department of Health, Education, and Welfare any individual income tax return made in respect of a tax imposed under chapter 1 of the Internal Revenue Code of 1939 or under chapter 1 or chapter 2 of the Internal Revenue Code of 1954, as may be needed in its administration of the provisions of Title II of the Social Security Act, as amended. Such authorization includes the furnishing of a copy of the return or any data on such return.

RUSSELL C. HARRINGTON,
Commissioner.

COMMISSIONER DELEGATION ORDER NO. 17 [9]

(Effective January 23, 1956)

Authority delegated to District Directors to issue determination letters under sections 401, 501, and 521 of the Internal Revenue Code of 1954.

1. There is hereby delegated to each District Director of Internal Revenue the authority to issue, in response to taxpayers' written requests and in accordance with applicable instructions, determination letters under the provisions of the Internal Revenue Code of 1954 with respect to:

(a) Initial qualification of stock bonus, pension, profit-sharing and annuity plans under section 401(a);

(b) Initial exemption from Federal income tax under section 501(a) of trusts forming a part of such plans, provided that the application of the provisions of sections 503 or 511, relating to prohibited transactions and unrelated business income tax, respectively, is not involved;

[8] 21 F. R. 654.
[9] Published in 21 F. R. 823; Commissioner Delegation Order No. 16 was not published.

(c) Amendments, curtailments, or terminations of such plans and trusts;

(d) Effect on qualification of such plans and exempt status of such trusts of investments of trust funds in the stocks or securities of the employer;

(e) Exemption from Federal income tax under section 501(a) of organizations described in sections 501(c) and (d), provided that such requests for exemption are of a routine nature in which the application of the provisions of section 501 to the facts shown on the exemption application is clear and does not present involved or questionable issues; and further provided that any such request does not involve the application of the provisions of sections 502, 503, 504, or 511 relating to (1) feeder organizations, (2) prohibited transactions, (3) denial of exemption, and (4) unrelated business income tax, respectively; and

(f) Exemption from Federal income tax under section 521(a) of organizations rescribed in section 521(b), provided that the taxpayer's request for exemption is of a routine nature in which the application of the provisions of section 521 to the facts shown on the exemption application is clear and does not present involved or questionable issues.

2. This Order supersedes Commissioner's Reorganization Orders No. 11 and 31, dated August 11, 1952 and April 28, 1954, respectively.[10]

RUSSELL C. HARRINGTON,
Commissioner.

COMMISSIONER DELEGATION ORDER NO. 20[11]

(Effective February 6, 1956)

Extension of time to pay excess profits, estate and gift taxes

Authority is hereby delegated to District Directors of Internal Revenue to grant extensions of time to pay excess profits, estate and gift taxes, including deficiencies.

This Order supersedes Commissioner's Reorganization Order No. 21, dated August 26, 1953 [C. B. 1953–2, 507].

RUSSELL C. HARRINGTON,
Commissioner.

COMMISSIONER DELEGATION ORDER NO. 21[12]

(Effective February 27, 1956)

Extension of time for filing returns and paying certain excise taxes.

Authority is hereby vested in District Directors of Internal Revenue to grant extensions of time to file returns and pay taxes respecting telegraph, telephone, radio and cable facilities, and transportation

[10] These Reorganization Orders were not published in the Internal Revenue Bulletin.
[11] Published in 21 F. R. 1111; Commissioner Delegation Orders No. 18 and 19 were not published.
[12] 21 F. R. 1520.

of persons and property, pursuant to Sections 6081(a), and 6161(a) of the Internal Revenue Code of 1954, and to make monthly deposits in payment of such taxes pursuant to Treasury Decision 6025, approved July 3, 1953 [C. B. 1953–2, 400].

This Order supersedes Commissioner's Reorganization Order No. 25, issued September 29, 1953 [C. B. 1953–2, 508].

O. GORDON DELK,
Acting Commissioner.

COMMISSIONER DELEGATION ORDER NO. 22 [13]

(Effective February 27, 1956)

Extension of time for filing estate tax returns

Authority is hereby vested in District Directors of Internal Revenue to grant extensions of time to file estate tax returns, such extensions not to exceed six (6) months from the due date.

This Order supersedes Commissioner's Reorganization Order No. 20, issued August 26, 1953 [C. B. 1953–2, 507].

O. GORDON DELK,
Acting Commissioner.

COMMISSIONER DELEGATION ORDER NO. 23 [14]

(Effective February 29, 1956)

Settlement of tort claims

1. Pursuant to Treasury Department Order No. 145 (Revision No. 1), dated May 6, 1953, there is hereby delegated to the Assistant Commissioner (Administration) and the Director, Operating Facilities Division:

(a) The authority, under 28 U. S. C. 2672, to consider, ascertain, adjust, determine, settle and pay claims for money damages of $1,000 or less, for injury, loss, or death caused by the negligent or wrongful act or omission of any employee of the Internal Revenue Service; and

(b) The authority to consider, ascertain, adjust and determine claims under the Act of December 28, 1922, 42 Stat. 1066.

2. The authority delegated herein to the Director, Operating Facilities Division, shall be subject to the direction and supervision of the Assistant Commissioner (Administration), who shall have authority to revise or modify all or any part of the authority delegated to the Director, Operating Facilities Division.

3. This Order supersedes Commissioner's Reorganization Order No. 32, dated June 10, 1954.[15]

RUSSELL C. HARRINGTON,
Commissioner.

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[13] 21 F. R. 1520.
[14] 21 F. R. 1520.
[15] This Order was not published in the Bulletin.

COMMISSIONER DELEGATION ORDER NO. 24[16]

(Effective February 29, 1956)

Authority to require records to be kept

District Directors of Internal Revenue are hereby authorized to require any person, by notice served upon him, to keep such records as shall show whether or not such person is liable for tax under the Internal Revenue Code of 1954.

This Order supersedes Commissioner's Reorganization Order No. 23, dated September 11, 1953 [C. B. 1953–2, 508].

RUSSELL C. HARRINGTON,
Commissioner.

COMMISSIONER DELEGATION ORDER NO. 31[17]

(Effective April 30, 1956)

Administration and enforcement of laws relating to distilled spirits, wines, beer, tobacco, and firearms.

1. There is hereby delegated to the Assistant Commissioner, Operations, and the Director, Alcohol and Tobacco Tax Division, the authority—

(a) to administer and enforce:

(1) Chapters 51, 52 and 53 of the Internal Revenue Code relating, respectively, to distilled spirits, wines, and beer, tobacco, and firearms, including the authority to supervise and regulate the liquor and tobacco industries, and the determination of appeals in administrative proceedings involving the denial of applications for industrial alcohol and tobacco permits and the annulment, revocation, and suspension of such permits,

(2) the Federal Alcohol Administration Act (27 U. S. C. Chapter 8), including the authority to accept or reject offers in compromise submitted pursuant to such Act, and the determination of appeals in administrative proceedings involving the denial of applications for beverage permits and the annulment, revocation, and suspension of such permits,

(3) the Federal Firearms Act (15 U. S. C. Chapter 18), and

(4) 18 U. S. C. 1262–1265, 3615, relating to the liquor traffic, and

(b) to remit or mitigate forfeiture of

(1) personal property seized as subject to administrative forfeiture under internal revenue laws, and

(2) vessels, vehicles, or aircraft seized as subject to administrative forfeiture under the customs laws for transportation or concealment therein in violation of the Act of August 9, 1939 (49 U. S. C. Chapter 11) of firearms in respect of which there have been violations of Chapter 53 of the Internal Revenue Code.

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[16] 21 F. R. 1520.
[17] Published in 21 F. R. 3083; Commissioner Delegation Orders No. 25, 26, 27, 28, 29 and 30 were not published.

2. The exercise of the authority delegated herein to the Director, Alcohol and Tobacco Tax Division, shall be under the direction and supervision of the Assistant Commissioner, Operations.

3. This order supersedes Commissioner's Reorganization Order No. Hdq. -8,[18] Operations Reorganization Order No. 1,[18] and Operations Reorganization Order No. 5.[18]

RUSSELL C. HARRINGTON,
Commissioner.

COMMISSIONER DELEGATION ORDER NO. 32[19]

(Effective May 1, 1956)

Authority of Director of International Operations

There is hereby delegated to the Director of International Operations authority, in administering and directing the functions of the International Operations Division, Office of Assistant Commissioner (Operations):

1. To perform those functions vested in the Secretary or his delegate by the Internal Revenue Code of 1954 which may be performed by a District Director of Internal Revenue under provisions of Treasury Regulations or Treasury Decisions; and

2. To perform any other functions of, and to exercise authorities vested in, District Directors of Internal Revenue by Commissioner Delegation Orders, or any other instrument currently in force and effect.[20]

The Director of International Operations is also authorized to perform the functions of the "competent authority," to the extent such functions may be delegated by the Commissioner, in connection with Tax Treaty matters for purposes of the activities of the International Operations Division.

RUSSELL C. HARRINGTON,
Commissioner.

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26 CFR 601.313: Collection of taxes. Rev. Proc. 56-1
(Also Part I, Section 5703; Sections 270.148, 270.192, 275.137, 275.181.)

The receipted copy of the respective order forms for cigar, cigarettes, tobacco, or snuff tax stamps, required to be retained by the manufacturer or importer, will be stamped by the District Director of Internal Revenue with the words "Received with Remittance" to evidence full payment of the cost of the stamps covered thereby.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to provide instructions for the receipting of Form 168, Order For Stamps—Cigars—Large—Various Classes; Form 172, Order For Stamps—Tobacco; Form 173,

[18] These Orders were not published in the Bulletin.
[19] 21 F. R. 3083.
[20] See Revenue Procedure 55-2, C. B. 1955-2, 898.

Order For Stamps—Snuff; Form 485, Order For Stamps—Cigarette and Small Cigar; and Form 923, Order For Stamps—Imported Manufactures.

SEC. 2. REQUIREMENTS OF REGULATIONS.

Sections 270.148(b) and 270.192(b) of the Regulations relating to Cigars and Cigarettes (Manufacturers, Importers, and Dealers) require a manufacturer or importer of cigars or cigarettes to retain a receipted copy of the stamp order form evidencing payment to the District Director of Internal Revenue of the cost of the stamps covered by the order forms. Section 275.137(b) and 275.181(b) of the Regulations relating to Manufactured Tobacco (Manufacturers, Importers, and Dealers) require a similar arrangement with respect to manufacturers and importers of manufactured tobacco (including snuff) relative to stamp order forms presented by them in connection with the purchase of tobacco and snuff stamps.

SEC. 3. PROCEDURE.

Since every order for cigar, cigarette, tobacco or snuff stamps must be accompanied by a remittance in the full amount, such order will be stamped "Received with Remittance" by the District Director of Internal Revenue to evidence full payment of the cost of the stamps covered by the order form.

SEC. 4. INQUIRIES.

Any inquiries concerning this procedure should be addressed to the Collection Division, Attention: O:C:PR.

SEC. 5. EFFECTIVE DATE.

The terms of this Revenue Procedure conform to instructions issued to District Directors of Internal Revenue which were effective as of November 22, 1955. Accordingly, this Revenue Procedure is effective November 22, 1955.

(Also Part I, Section 501.) Rev. Proc. 56–2

A form of statement furnished to applicant credit unions by the Credit Union National Association is acceptable by the Internal Revenue Service as meeting the requirements relating to the evidence to be filed by State Chartered credit unions claiming exemption from Federal income tax.

Every organization claiming exemption from Federal income tax must file with the District Director of Internal Revenue certain information acceptable as proof of exemption. In the case of state chartered credit unions claiming such exemption under section 501(c)(14) of the Internal Revenue Code of 1954, a statement similar to the one outlined below (or one containing substantially the same information) will be accepted by the Internal Revenue Service as meeting the requirements relating to evidence to be filed by such organizations. When properly executed, such statement will serve in lieu of copies of articles of incorporation, bylaws, and financial statements. This form will be furnished the applicant credit union by the Credit Union National Association and will not be reproduced by the Internal Revenue Service for distribution.

Date _____

CLAIM FOR EXEMPTION FROM FEDERAL INCOME TAX

The undersigned _____ Credit Union, Inc.
(Complete name)
_____ a credit union operating under
(Complete address, including street & number)
the credit union law of the State of _____ claims exemption from Federal income tax and supplies the following information relative to its operation:

(1) Date of incorporation _____.

(2) It was incorporated under the credit union law of the State of _____, and is being operated under uniform bylaws adopted by said State.

(3) In making loans the State credit union law requirements including their purposes, security, and rate of interest charged thereon, are complied with.

(4) Its investments are limited to securities which are legal investments for credit unions under the State credit union law.

(5) Its dividends on shares, if any, are distributed as prescribed by the State credit union law.

I, the undersigned, a duly authorized officer of the _____, Credit Union, Inc., declare that the above information is a true statement of facts concerning the credit union.

_____ _____
(Signature of officer) (Title)

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26 CFR 601.313: Collection of taxes. (Also Part I, Section 5721; Sections 270.141 and 275.131.)

Rev. Proc. 56-3 [21]

Manufacturers of tobacco, cigars, and cigarettes must make an inventory, for each factory, of all tobacco materials held at the beginning of business on January 1, 1956.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to advise manufacturers of tobacco products that they must make an inventory of all tobacco materials held at the beginning of business on January 1, 1956.

SEC. 2. REQUIREMENTS OF LAW.

Section 5721 of the Internal Revenue Code of 1954 requires that every manufacturer of articles shall make a true and accurate inventory at such time, in such manner and form, and to include such items as the Secretary or his delegate shall by regulations prescribed.

SEC. 3. GENERAL INSTRUCTIONS.

Pursuant to the above authority of law, every manufacturer of tobacco, cigars, and cigarettes is required to make an inventory, for each factory operated by such manufacturer, of tobacco materials as of the beginning of business on January 1, 1956. The inventory shall show the quantities of (a) unstemmed leaf tobacco (to include Black Fat), (b) stemmed leaf tobacco (to include Perique), (c) tobacco in process, (d) scraps, cuttings, and clippings, (e) siftings, and (f) stems (if received or intended for use in manufacture), held at the beginning of business January 1, 1956. Report of the inventory of tobacco materials shall be made in section 1 (columns (a) through (f)) of Form

[21] The requirements of this Revenue Procedure were communicated to all persons concerned by Industry Circular No. 55-36, dated November 10, 1955.

2130, Inventory—Manufacturer of Tobacco, or Form 2131, Inventory—Manufacturer of Cigars and Cigarettes, as the case may be. In addition, the materials reported on such inventory shall be entered in the factory revenue record, Form 73–Part 1, Book to be Kept by Manufacturers of Large Cigars, Form 73–Part 2, Book for Use by Manufacturers of Small Cigarettes, Large Cigarettes, or Small Cigars, or Form 74, Book to be Kept by Manufacturers of Tobacco and Snuff, as the case may be. However, in the case of Form 73–Parts 1 and 2, tobacco in process, siftings, and stems received for use in manufacture shall be included as scraps, cuttings, and clippings, and in the case of Form 74, siftings shall be included as scraps, cuttings, and clippings.

SEC. 4. SPECIAL ENTRIES IN FORMS 2130 AND 2131.

In the preparation of Form 2130 or 2131 for the purpose of this inventory, each manufacturer should make a check mark in the special inventory block at the bottom of the form. In the declaration, above the space for the signature of the manufacturer, the words "manufactured tobacco, and stamps" in the case of Form 2130, and the words "cigars and cigarettes, and stamps," in the case of Form 2131, should be stricken out.

SEC. 5. FORWARDING OF INVENTORY.

The inventory on Form 2130 or 2131 shall be forwarded to the Assistant Regional Commissioner, Alcohol and Tobacco Tax, with the monthly report, Form 2134 or 2136, for December 1955, for the factory concerned.

SEC. 6. INQUIRIES.

Inquiries in regard to this Revenue Procedure should refer to the number thereof and should be directed to the appropriate Assistant Regional Commissioner, Alcohol and Tobacco Tax.

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26 CFR 601.311: Imposition of taxes; Regulations.
(Also Part I, Section 7805.)

Rev. Proc. 56–4

Information covering areas where problems or different interpretations of the Regulations relating to Dealers in Tobacco Materials are considered likely to arise with respect to permits, trade name certificates, bonds, and records.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to provide certain information as an aid in the uniform and orderly transition from the provisions of previous Regulations 8, insofar as they relate to dealers in leaf tobacco and quasi manufacturers of tobacco, to the provisions of the Regulations relating to Dealers in Tobacco Materials, published in the Federal Register on October 8, 1955, and effective on that date.

SEC. 2. PERMITS.

The Assistant Regional Commissioner, Alcohol and Tobacco Tax, will distribute to each person now qualified as a dealer in leaf tobacco or quasi manufacturer of tobacco in his region Form 2093, Application

for Permit, with instructions as to the documents required to be furnished with such application. In order for the dealer in leaf tobacco or quasi manufacturer of tobacco to continue his operations, it will be necessary that the application for permit be made without undue delay. An application for permit must be filed for each establishment operated by the dealer and shall show the location of the establishment and each outside place of storage for tobacco materials, to be covered under the bond of the dealer, if such outside place of storage is not separately qualified as the establishment of a dealer in tobacco materials. Where a person is operating an establishment as a dealer in leaf tobacco and also operates a factory as a quasi manufacturer of tobacco, a single application to cover both establishments will be sufficient. Under section 280.50 of the Regulations relating to Dealers in Tobacco Materials, persons who merely store or fumigate tobacco materials solely for dealers in tobacco materials, for manufacturers of tobacco products, for farmers or growers of tobacco, or for bona fide associations of farmers or growers of tobacco, are not required to qualify as dealers in tobacco materials and, therefore, need not file an application. Similiarly, under section 280.54 of the regulations speculators in leaf tobacco, also referred to as "pinhookers," are not required to qualify as dealers in tobacco materials and need not file an application. The permit issued to a dealer in tobacco materials will bear the same number, wherever possible, as that now assigned to his current establishment as a dealer in leaf tobacco, or to his factory as a quasi tobacco manufacturer. Where a dealer desires to add an outside place of storage for his tobacco materials, after the issuance to him of the original permit as such a dealer, he is required to make application on Form 2098, Application for Amended or Additional Permit, to the Assistant Regional Commissioner, Alcohol and Tobacco Tax, for an additional permit to cover such additional outside place of storage. This application must be supported by Form 2105, Extension of Coverage of Bond.

SEC. 3. TRADE NAME CERTIFICATE.

The refurnishing of a trade name certificate is not intended, under section 280.64 of the regulations, where the Assistant Regional Commissioner already possesses such a certificate furnished by the dealer or quasi manufacturer in connection with his prior qualification.

SEC. 4. BOND.

Form 2101, Bond–Dealer in Tobacco Materials, required to be furnished under section 280.65, upon original qualification, shall, in addition to the dealer's establishment, cover all outside places of storage shown on the dealer's application for original permit, Form 2093. Thereafter, the addition of any place of storage must be supported by an extension of coverage of bond. To ascertain the amount of the bond required of a dealer who has been qualified during the preceding twelve months, such dealer will use the total quantity of tobacco materials received by him during the twelve month period, divided by twelve, to establish a monthly average. In the case of a dealer commencing business, or a dealer operating for less than twelve months, it will be necessary for him to estimate the monthly average quantity of tobacco materials received.

SEC. 5. RECORDS.

.01 The records, required under section 280.127, must be complete and adequate, consistent with accepted commercial practice, with respect to all tobacco materials received (except with respect to samples as provided by section 280.124), lost or destroyed, and shipped or delivered. The keeping of Record 59, Record of Dealer in Leaf Tobacco, and Form 74, Book to be Kept by Manufacturer of Tobacco and Snuff, and the making of monthly reports on Form 775, Report of Dealer in Leaf Tobacco, and Form 62A, "Quasi" Tobacco Manufacturer's Monthly Return, are no longer required.

.02 The preparation of Form 774, Tobacco Invoice, will be required only in connection with shipments of tobacco materials for export, and only until such time as the new export regulations in 26 CFR Part 290 become effective.

SEC. 6. INQUIRIES.

Inquiries in regard to this Revenue Procedure should refer to the number thereof and should be directed to the Director, Alcohol and Tobacco Tax Division, for the attention of O:AT:T.

SEC. 7. EFFECTIVE DATE.

This Revenue Procedure is effective October 8, 1955, the effective date of the Regulations relating to Dealers in Tobacco Materials.

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26 CFR 601.301: Imposition of taxes, qualification requirements, and regulations. (Also Part III–A, Section 5009; Section 225.789.) — Rev. Proc. 56–5

Export stamps, required on all packages of distilled spirits intended for exportation, will be issued by the storekeeper-gaugers rather than by District Directors of Internal Revenue.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to provide interim instructions for the issuance of export stamps to proprietors by storekeeper-gaugers rather than by District Directors of Internal Revenue. The regulations will be revised to adopt such interim procedure.

SEC. 2. BACKGROUND.

Under the provisions of the regulations, export stamps are required to be placed on distilled spirits and alcohol withdrawn without payment of tax for (a) exportation, (b) use as supplies on vessels and aircraft, (c) transfer to customs manufacturing bonded warehouses, or (d) deposit in foreign-trade zones. Such stamps are prescribed for packages and other bulk containers of distilled spirits and for all containers of alcohol (including cases of bottled alcohol) so withdrawn. Effective January 1, 1955, no charge is made for such stamps on issuance to proprietors under section 5009 of the Internal Revenue Code of 1954. Therefore, it is now considered feasible to provide for the more convenient issuance of such stamps by the storekeeper-gauger, as in the case of wholesale liquor dealer's stamps, rather than by the District Directors. Further, continuing the requirement that such stamps be procured from the District Directors would in large

measure nullify any advantage to the proprietor in cases where the storekeeper-gauger is authorized to execute the permit for withdrawal.

SEC. 3. ISSUANCE TO PROPRIETORS.

Accordingly, where export stamps are required to be used, proprietors will no longer submit the withdrawal application and report of gauge to the District Directors for issuance of such stamps. Instead, the storekeeper-gauger will issue the export stamps to the proprietor when the permit for removal has been executed.

SEC. 4. EFFECTIVE DATE.

This Revenue Procedure shall be effective March 1, 1956.

(Also Part I, Section 6103; 26 CFR 301.6103 (a)–100. Rev. Proc. 56–6

Rules relating to the inspection of such individual income tax returns by any duly authorized official or employee of the Department of Health, Education, and Welfare, as may be needed in the administration of the provisions of Title II of the Social Security Act.

SECTION 1. PURPOSE.

This Revenue Procedure sets forth the procedures relating to the inspection of individual income tax returns made in respect of a tax imposed under chapter 1 of the Internal Revenue Code of 1939, or under chapter 1 or 2 of the 1954 Code, by the Department of Health, Education, and Welfare.

SEC. 2. AUTHORITY TO INSPECT.

.01 Pursuant to Executive Order 10619, C. B. 1955–2, 495, Treasury Decision 6135, I. R. B. 1955–29, 6, Treasury Decision 6136, C. B. 1955–2, 552, and Commissioner Delegation Order No. 15, dated January 11, 1956, 21 F. R. 654, page 1012, this Bulletin, District Directors of Internal Revenue shall, upon proper application, permit inspection of such individual income tax returns by any duly authorized official or employee of the Department of Health, Education, and Welfare, as may be needed in the administration of the provisions of Title II of the Social Security Act, as amended. Applications shall be made, in writing, by a duly authorized officer or employee of the Department of Health, Education, and Welfare and shall be addressed to the District Directors having custody of the returns, identifying the taxpayers, their addresses, and the taxable year involved, and indicating that the information is desired and will be used solely in connection with the administration of Title II of the Social Security Act, as amended.

.02 Permission to inspect the returns shall extend to the returns themselves and to schedules, information returns, etc., designed to be supplemental to or become a part of the returns, as well as certain records and reports relating to the returns. The policy with respect to what documents may also be inspected is generally as follows:

1. Schedules, information returns, protests, briefs, face of claims, waivers, and other statements or documents desiged to be supplemental to or become part of the return, may also be inspected;

2. Examining agents' reports may be inspected to the extent that such reports have previously been furnished to the taxpayers; therefore, the transmittal letter portion of an agent's report, or a separate confidential report, which contains information for the use of Internal Revenue Service only, may not be inspected;

3. Conference reports may not be inspected with the exception of the pages showing recomputation of tax liability:

4. Work papers of examining agents, engineers' reports, cover letters of the reports in which opinions are expressed, reports of special agents, and interoffice communications, may not be inspected unless specific authorization is given by the Commissioner;

5. Inspection of claims for refund will be limited to the face of the claim only, since the back of the claim contains Internal Revenue Service records.

SEC. 3. COPIES OF RETURNS.

Officials of the Department of Health, Education, and Welfare authorized to inspect returns and related documents will also be furnished, upon written application, copies of such returns and related documents.

SEC. 4. PROCEDURE FOR FURNISHING SERVICES.

.01 Inspection of the returns after permission has been granted shall be made in the office of the District Director having custody of the returns, but only in the presence of an internal revenue officer or employee designated by the District Director to make such returns available and during the normal hours of business of such office. The inspection of the returns shall be arranged for a time mutually agreeable to the District Director and the designated representative of the Department of Health, Education, and Welfare.

.02 No charges will be made pursuant to this Revenue Procedure for copies of returns and related documents which are furnished to the Department of Health, Education, and Welfare.

SEC. 5. EFFECTIVE DATE.

This Revenue Procedure is effective as of January 11, 1956.

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26 CFR 601.301: Imposition of taxes, qualification requirements, and regulations. (Also Part III–A, Section 5331; Section 182.140.) — Rev. Proc. 56–7

Permits to use specially denatured alcohol may be amended to include all articles and preparations covered by Forms 1479–A approved during the period covered by the permit by the filing of one Form 1479.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to provide instructions for the amendment of Form 1481, Permit to Use Specially Denatured Alcohol, to include all articles or preparations covered by Forms 1479–A, Formula for Preparation Made with Specially Denatured Alcohol, approved during the period covered by the Form 1481.

SEC. 2. BACKGROUND.

Under the procedures which have been followed with respect to the amendment of basic permits for the use of specially denatured alcohol, it has been necessary, whenever a new article or preparation was to be manufactured pursuant to approved Form 1479–A, for the permittee to submit application on Form 1479, Application for Permit to Use Specially Denatured Alcohol, for the amendment of the basic permit to include the new article or preparation. As a result of studies in regional offices and the National Office, it has been determined that a simplified procedure can be established within the scope of present regulations whereby a permittee can file one application on Form 1479 to amend Form 1481 to contain a statement including all articles or preparations covered by Forms 1479–A approved during the period covered by the permit. This would permit the amendment of Form 1481, one time, to permit additional articles or preparations covered by approved Forms 1479–A to be manufactured, without the necessity of preparing additional applications on Form 1479 for this type of amendment of the basic permit.

SEC. 3. PREPARATION OF APPLICATION FOR AMENDMENT OF PERMIT TO USE SPECIALLY DENATURED ALCOHOL.

Manufacturers or users of specially denatured alcohol desiring to prepare an application, Form 1479, to amend a permit to use specially denatured alcohol, Form 1481, for only the purpose of adding the name of a new article or preparation for which a formula on Form 1479–A has been approved, will prepare his first such application in a manner to include all articles and preparations covered by Forms 1479–A approved during the period covered by the permit. He will enter on Form 1479, in the space designated "Purpose for which filed," the statement "To amend basic permit, Form 1481, to include in item (3), column (a), all articles and preparations covered by Forms 1479–A approved during the period covered by the permit," and enter in the space headed "Article or Preparation to Be Manufactured" the sentence "The articles and preparations are those listed in the existing permit and those covered by Forms 1479–A approved during the period covered by the permit."

SEC. 4. INQUIRIES.

Inquiries in regard to this Revenue Procedure should be addressed to the appropriate Assistant Regional Commissioner, Alcohol and Tobacco Tax.

SEC. 5. EFFECTIVE DATE.

This Revenue Procedure is effective February 9, 1956.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 401, 501, and 521.)

Rev. Proc. 56–8 [22]

Authority delegated to District Directors to issue determination letters under sections 401, 501, and 521 of the Internal Revenue Code of 1954.

[22] This Revenue Procedure is based on Comissioner Delegation Order No. 17 (21 F. R. 823), appearing on page 1012 of this Bulletin.

1. There has been delegated to each District Director of Internal Revenue the authority to issue, in response to taxpayers' written requests and in accordance with applicable instructions, determination letters under the provisions of the Internal Revenue Code of 1954 with respect to:

(a) Initial qualification of stock bonus, pension, profit-sharing and annuity plans under section 401(a);

(b) Initial exemption from Federal income tax under section 501(a) of trusts forming a part of such plans, provided that the application of the provisions of section 503 or 511, relating to prohibited transactions and unrelated business income tax, respectively, is not involved;

(c) Amendments, curtailments, or terminations of such plans and trusts;

(d) Effect on qualification of such plans and exempt status of such trusts of investments of trust funds in the stocks or securities of the employer;

(e) Exemption from Federal income tax under section 501(a) of organizations described in section 501(c) and (d), provided that such requests for exemption are of a routine nature in which the application of the provisions of section 501 to the facts shown on the exemption application is clear and does not present involved or questionable issues; and, further, provided that any such request does not involve the application of the provisions of sections 502, 503, 504, or 511 relating to (1) feeder organizations, (2) prohibited transactions, (3) denial of exemption, and (4) unrelated business income tax, respectively; and

(f) Exemption from Federal income tax under section 521(a) of organizations described in section 521(b), provided that the taxpayer's request for exemption is of a routine nature in which the application of the provisions of section 521 to the facts shown on the exemption application is clear and does not present involved or questionable issues.

2. For the general procedures applicable to the above delegation, see Rev. Rul. 32, C. B. 1953–1, 265; Rev. Rul. 54–164, C. B. 1954–1, 88; and Rev. Rul. 54–172, C. B. 1954–1, 394.

3. The provisions of this Revenue Procedure are effective as of January 23, 1956.

(Also Part I, Section 761; 1.761–1.) Rev. Proc. 56–9

Any unincorporated organization entitled to make the election under section 761(a) of the Internal Revenue Code of 1954 for the filing of partnership returns or other information in lieu thereof, required by the regulations under section 761, will be allowed an extension of six months from the due date prescribed for the filing of such returns or other information in lieu thereof.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to clarify the provision of section 761 of the Internal Revenue Code of 1954, pertaining to the election allowed members of an unincorporated organization to exclude such organization from the application of the partnership provisions of the Code.

SEC. 2. BACKGROUND.

.01 Under subchapter K, Partners and Partnerships, section 761 of the Code provides, in part, that 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 such organization is availed of for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, and if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

.02 I. T. 3930, C. B. 1948–2, 126, gives the status for Federal income tax purposes of joint operating agreements commonly entered into between coowners of oil and gas properties or leaseholds, under the 1939 Code, and requires, under certain circumstances, the filing of qualified partnership returns.

.03 Section 6072(a) of the 1954 Code provides that in the case of partnership return, etc., those made on the basis of the calendar year shall be filed on or before the 15th day of April following the close of the calendar year and returns made on the basis of a fiscal year shall be filed on or before the 15th day of the fourth month following the close of the fiscal year, except as otherwise provided. In this connection, section 6081(a) of the 1954 Code provides that the Secretary or his delegate may grant a reasonable extension of time for filing any return, declaration, statement, or other document required. However, no such extension shall be for more than six months, except in the case of taxpayers who are abroad.

SEC. 3. EXTENSION OF TIME FOR ELECTION.

Because regulations under section 761 were not promulgated until May 23, 1956, any unincorporated organization entitled to make the election under section 761(a) of the Code for the filing of partnership returns, or other information in lieu thereof, required by the regulations under section 761, will be allowed an extension of six months from the due date prescribed for filing such returns. This is the maximum extension allowed by section 6081. Accordingly, returns for the calendar year 1955 required by the regulations under section 761 should be filed not later than October 15, 1956.

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26 CFR 601.401: Employment taxes. (Also Part I, Section 6011.) Rev. Proc. 56–10

Subject to certain conditions, the Internal Revenue Service will accept substitutes for Form 941a, "Continuation Sheet For Form 941, 941 VI, or 943," in lieu of the official form printed by the Government Printing Office.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to state the policy of the Internal Revenue Service relating to acceptance of substitutes for Form 941a, "Continuation Sheet For Form 941, 941 VI, or 943," for filing purposes in lieu of the official form printed by the Government Printing Office.

SEC. 2. BACKGROUND.

.01 Form 941, "Employer's Quarterly Federal Tax Return," provides space in schedule A, "Quarterly Report of Wages Taxable under the Federal Insurance Contributions Act," for listing the account numbers, names, and wages of employees, as well as the State in which each employee is employed. Form 941a is available to employers who need additional space for the listing of employees.

.02 Substitutes for Form 941a may be privately printed with slight variation of format, and used without specific approval of the Internal Revenue Service if the specifications enumerated in section 3 are met.

SEC. 3. SPECIFICATIONS.

.01 *Basic form.*—The latest revision of the prescribed Form 941a should be used as the basis for the privately printed form. A copy of the latest revision of Form 941a may be obtained from any District Director of Internal Revenue.

.02 *Color and quality of ink and paper.*—Black ink on white paper, both of quality as good as that used by the Government; the paper to be of substantially the same weight and texture as that used in the official form which is printed on substance 32-pound white-writing—basis 1,000 sheets, 17 x 22.

.03 *Typography.*—Type to be not smaller than the corresponding type of the official form and as nearly as possible of the same font.

.04 *Dimensions.*—The official Form 941a, revised January 1956, is 7⅞ inches wide by 10½ inches deep. The substitute forms may vary in width from 7½ inches to 8½ inches, and in depth from 10½ inches to 10¾ inches.

.05 *Column widths.*—The columns of the substitute form may be wider or narrower than the corresponding columns of the prescribed form 941a; however, each column must be wide enough for adequate reporting of the information called for therein.

.06 *Additional columns.*—If one or more additional columns are included on the form for reporting information not called for on the official Form 941a, such columns should be blocked out on the original copy.

.07 *Column omitted.*—The column, "STATE, POSSESSION, OR TERRITORY OF EMPLOYMENT (or 'outside U. S.')" may be omitted from the substitute form provided that such caption, together with the information called for, is placed in the upper portion of the substitute form, and all of the employees listed on a single page of the form have the same State, etc., of employment.

.08 *Vertical lines.*—The vertical lines which separate the four columns of the prescribed Form 941a may be, on the substitute forms, either omitted or replaced by lighter lines provided the required information is entered under appropriate column headings.

.09 *Omission of instructions.*—The instructions appearing on the back of the prescribed Form 941a may be omitted, but such instructions should be followed in the preparation of the substitute forms.

.10 *The Government Printing Office symbols.*—To be omitted.

SEC. 4. ADDITIONAL INSTRUCTIONS.

.01 Only the originals of privately printed forms should be filed with the District Director; carbon copies are not acceptable.

.02 If the forms are printed in continuous style, they must be separated before filing. Marginal holes for pin feed devices and stubs at the top or bottom of the form must be removed before filing with the District Director. The forms as filed must be within the dimensions specified in section 3.04, above.

.03 Both the account number and the name of an employee may be entered in either of the columns captioned, "Employee's Account Number" or "Name of Employee" provided the account number is listed above the employee's name. It is preferred that the names and account numbers of employees to whom no taxable wages were paid during the quarter covered by the return be omitted. If listed, however, they should be lined through before the report is submitted.

SEC. 5. SUBSTITUTES NOT MEETING STATED CONDITIONS.

Proposed substitutes for Form 941a which do not meet the conditions stated in section 3, above, should be forwarded by letter to the Commissioner of Internal Revenue, Attention O:C:PF, Washington 25, D. C., for approval.

SEC. 6. EFFECTIVE DATE.

This Revenue Procedure is effective immediately.

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26 CFR 601.103: Summary of tax procedure. Rev. Proc. 56–11
(Also Part I, Section 534.)

Registered notification letters will be mailed to corporations if it is proposed to issue a deficiency notice containing the allegation that earnings and profits have been permitted to accumulate beyond the reasonable needs of the business.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to set forth procedures for the preparation and mailing of the notification letter provided for by section 534(b) of the Internal Revenue Code of 1954 in all cases where the examination of a corporation discloses evidence that its earnings and profits have been permitted to accumulate beyond the reasonable needs of the business.

SEC. 2. BACKGROUND.

.01 Section 534(a) of the Code provides, in general, that the burden of proof before the Tax Court of the United States, with respect to the allegation that a corporation has permitted earnings and profits to accumulate beyond its reasonable business needs, shall be on the Commissioner of Internal Revenue if a notification was not sent to the taxpayer in accordance with section 534(b). The notification must be sent by registered mail and must inform the taxpayer that the proposed notice of deficiency will include an amount with respect to the accumulated earnings tax imposed by section 531. Within thirty days (or such greater period as may be prescribed by regulations) after the mailing of the notification, the taxpayer may submit a statement of the grounds, together with sufficient supporting facts, on which it relies to establish that its earnings and profits had not been accumulated beyond the reasonable needs of the business.

.02 Section 4 of the Act of August 11, 1955, Public Law 367, 84th Cong., 69 Stat. 689, 26 U. S. C. 4218, C. B. 1955–2, 768, amended

section 534 of the Code to provide that the notification requirement shall apply to all proceedings tried on the merits before the Tax Court after the date of enactment of the amendment. Accordingly, section 534 is now also applicable to taxable years to which section 102 of the Internal Revenue Code of 1939 applies.

SEC. 3. PROCEDURE.

.01 If it is determined upon examination that a corporation was formed or availed of for the purpose of avoiding income tax on its stockholders by permitting its earnings and profits to accumulate, the notification letter will be mailed prior to the mailing of the deficiency notice. As a general rule, the deficiency notice will not be issued until the period of time, including any extension thereof, for submission of the statement has elapsed. These procedures, however, will be appropriately modified in any case where the impending expiration of the statutory period of limitation, or similar compelling circumstances, require earlier issuance of the deficiency notice.

.02 Upon receipt in the office of a District Director of Internal Revenue or in the office of the Regional Appellate Division, of a timely statement submitted in response to the notification letter, the statement shall be carefully considered and, if the conclusion is reached that taxpayer has successfully demonstrated that its earnings and profits had not been accumulated beyond the reasonable needs of the business, the proposed allegation shall be abandoned.

.03 A separate notification letter need not be sent prior to the mailing of the notice of deficiency if a jeopardy assessment under section 273(a) of the 1939 Code or section 6861(a) of the 1954 Code is made. In such instances, the deficiency notice, which must be mailed within 60 days after the date of assessment, shall itself constitute the notification if it informs the taxpayer that the deficiency includes the tax imposed by section 102 (1939 Code) or section 531 (1954 Code). The taxpayer's statement may then be included in its petition to the Tax Court.

SEC. 4. AUTHORITY TO ISSUE NOTIFICATION LETTERS.

Operating officials who hold delegations or redelegations of authority to sign notices of deficiency are also empowered to sign notification letters, such authority being derived from Treasury Department Order 150–36, C. B. 1954–2, 733.

SEC. 5. INQUIRIES.

Inquiries relating to this Revenue Procedure should be addressed to the Assistant Commissioner (Operations), for the attention of O:A:PPr.

(Also Part I, Section 401.) Rev. Proc. 56–12

Procedure as to determinations with respect to the qualification of pension, annuity, profit-sharing, and stock bonus plans under section 401(a) of the Internal Revenue Code of 1954, and the status for exemption of related trusts under section 501(a) of the Code.
Revenue Ruling 32, C. B. 1953–1, 265, superseded.
Revenue Ruling 54–172, C. B. 1954–1, 394, modified.

SECTION 1. PURPOSE AND GENERAL INFORMATION.

.01 The purpose of this Revenue Procedure is to prescribe procedures as to determinations with respect to the qualification of pension,

annuity, profit-sharing, and stock bonus plans under section 401(a) of the Internal Revenue Code of 1954, and the status for exemption of related trusts under section 501(a) of the Code.

.02 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, which meets the requirements of section 401(a) of the Code, constitutes a qualified trust under such section, and is exempt under section 501(a) of the Code unless exemption is denied under section 502 (relating to feeder organziations) or 503 (relating to prohibited transactions). Such a trust is required to file an annual return as provided by section 6033 of the Code. Form 990–P. U. S. Return of Employees' Trust described in Section 401(a) and exempt under section 501(a) of the Internal Revenue Code of 1954, is used for this purpose. An exempt trust may, however, be subject to tax under section 511 on unrelated business income. Unrelated business income is reported on Form 990–T, U. S. Exempt Organization Business Income Tax Return. A nontrusteed annuity plan which meets the requirements of section 401(a) (3), (4), (5), and (6) may confer special tax treatments provided for under other sections of the Code, such as section 403(a)(2) (long-term capital gain treatment) and section 404(a)(2) (deductions for employer contributions for the purchase of retirement annuities), if the additional provisions of such other sections are also met. Advance determination letters as to the qualification of pension, annuity, profit-sharing, and stock bonus plans under section 401(a), and the status for exemption of related trusts under section 501(a), are not required under the Code or corresponding regulations as a condition precedent for obtaining any of the tax benefits pertaining to qualified plans and exempt trusts. If requested by taxpayers, however, such advance determination letters are issued in accordance with the procedures set forth below.

SEC. 2. ADVANCE DETERMINATION LETTERS.

.01 The advance determination letters here contemplated are issued with respect to consummated or proposed transactions relating to:

(a) The initial qualification of a plan and, if trusteed, the status for exemption of a trust forming a part thereof;

(b) Compliance with the applicable requirements of foreign situs trusts as to taxability of beneficiaries (section 402(c)) and deductions for employer contributions (section 404(a)(4));

(c) Amendments to plans and trusts;

(d) Curtailments of plans;

(e) Terminations of plans and trusts; and

(f) The effect on the qualification of the plan, and status for exemption of the trust forming a part thereof, of an investment of trust funds in the stock or securities of the employer or controlled corporation (ownership of 50 percent or more of all voting stock or 50 percent or more of the total value of shares of all classes of stock).

.02 All requests for determination letters within the purview of section 2.01 hereof, together with the applicable supporting data, are to be filed separately (apart from the data furnished with the

employer's income tax return) in the office of the District Director of Internal Revenue having jurisdiction in the area prescribed as follows:

(a) In the case of a single employer, where the principal place of business of such employer is located;

(b) In the case of a plan of a parent and subsidiary companies, where the principal place of business of the parent company is situated regardless of whether consolidated returns are filed;

(c) In the case of an industry-wide plan (a plan established in a particular industry by all subscribing employers, some of whom are located in areas within the jurisdiction of more than one Director's office), where the trustee's principal place of business is located or, if more than one trustee, where the usual place of meeting of the trustees is held;

(d) In the case of a pooled fund arrangement (individual trusts under separate plans pooling their funds for investment purposes through a master trust), the request on behalf of the master trust is to be filed with the director's office where the principal place of business of such trust is located, but requests for the participating trusts and related plans are to be filed where the principal place of business of each employer is located or, in the case of parent and subsidiary companies, where the principal place of business of the parent company is located, regardless of whether consolidated returns are filed.

(e) In the case of a plan of multiple employers not otherwise here provided for, where the trustee's principal place of business is located or, if more than one trustee or if nontrusteed, where the usual place of meeting of the trustees or plan supervisors is held.

.03 All requests for determination letters are to be accompanied by information (copies not required), to the extent pertinent, as follows:

(a) For the initial qualification of a plan, or compliance with the applicable requirements of foreign situs trusts, the information called for under section 1.404(a)-2 of the Income Tax Regulations [23] (section 39.23(p)-2 of Regulations 118), and information showing: (i) type of organization of employer, (ii) date incorporated, in the case of a corporation, or date business commenced, in the case of other type of organization, (iii) nature of employer's business, and (iv) whether predecessor business, if any, was a corporation, an individual proprietorship or a partnership, name of predecessor, and when transfer took place.

(b) For an amendment, a copy of the amendment and, unless previously filed in connection with a written request for a determination for the same year for which the amendment is to become effective, or if the amendment changes the requirements for coverage or contributions or benefits, the information called for under section 1.404(a)-2 of the Income Tax Regulations [23] (section 39.23(p)-2 of Regulations 118), and, unless previously furnished,

[23] Section 1.404(a)-2 of the Income Tax Regulations herein referred to was published in proposed form, with notice of rule making, in 20 Federal Register 6455, on September 1, 1955. It is contemplated that final regulations on this particular section will be promulgated without change and that publication will be made in the near future. [EDITOR'S NOTE: Publication in final form has been made as T. D. 6203, I. R. B. 1956-41, 7]

information showing: (i) type of organization of employer, (ii) date incorporated, in the case of a corporation, or date business commenced, in the case of other type of organization, (iii) nature of employer's business, and (iv) whether predecessor business, if any, was a corporation, an individual proprietorship or a partnership, name of predecessor, and when transfer took place.

(c) For a curtailment or termination, the information called for in Exhibit "A" hereof; and

(d) For an investment of trust funds in the stock or securities of the employer, the information called for in Exhibit "B" hereof, without duplicating information previously filed. It should be noted that even if a request for such a determination letter is not made, section 1.401–1(b)(5)(ii) of the Income Tax Regulations [24] (section 39.165–1(a)(6) of Regulations 118) requires that a full disclosure be made where trust funds are invested in stock or securities of, or loaned to, the employer. The notification is to consist of the information called for in Exhibit "B" and is to be filed with the appropriate Director's office, as provided for in section 2.02 hereof.

.04 The District Director of Internal Revenue is responsible for the issuance of determination letters within the contemplation of section 2.01 hereof. Such letters will not be issued, however, where the determination requested is primarily one of fact, such as the market value of property or the adequacy of security behind a loan. In such cases the determination will be made upon examination of the applicable tax returns. A favorable determination letter on an investment of trust funds in stock of the employer corporation will contain the statement: "The opinion herein expressed, however, is conditioned on the purchase of such stock at a price not in excess of the fair market value thereof." The letters herein contemplated contain opinions as to the status for qualification and exemption of the plans and trusts referred to therein, and also serve as a basis for determining deductions for employer contributions thereunder. A favorable determination, however, is not to be taken as an indication that contributions are necessarily deductible as made. Regardless of whether an advance determination letter is obtained, the allowability of deductions for employer contributions will be determined upon examination of the applicable tax returns in accordance with the limitations, and subject to the conditions, of section 404 of the Code. Rulings and opinions pertaining to matters other than those under section 2.01 hereof, such as taxability of distributees, application of the principles relating to deductions for employer contributions, and determinations as to whether prohibited transactions are involved and as to unrelated business taxable income, are issued through the National Office. Requests therefor should be addressed to Commissioner of Internal Revenue, Washington 25, D. C.

SEC. 3. REVIEW OF DETERMINATION LETTERS.

All determination letters issued by District Directors under the procedure herein set forth are subject to post review in the National Office under the jurisdiction of the Assistant Commissioner (Technical).

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[24] Section 1.401–1(b)(5)(ii) of the Income Tax Regulations was published in proposed form, with notice of rule making, in 20 Federal Register 6455, on September 1, 1955. It is also contemplated that final regulations on this particular subsection will be promulgated without change. [EDITOR'S NOTE: Publication in final form has been made as T. D. 6203, I. R. B. 1956–41, 7]

SEC. 4. REQUESTS FOR ADVICE FROM FIELD OFFICES.

Requests for advice from District Directors concerning matters within the contemplation of section 2.01 hereof will be acted upon in the National Office, under the jurisdiction of the Assistant Commissioner (Technical), and advice furnished for appropriate disposition of controversial issues. If the taxpayer requests the District Director to refer an issue to the National Office, he will be advised through the District Director's office whether his request will be complied with, and, if so, when referral is made. In such event, the taxpayer will be granted a conference in the National Office, if requested, and he may furnish a brief or memorandum with respect to the points at issue.

SEC. 5. TAXPAYERS' REQUESTS FOR CONFERENCES AND REVIEW IN NATIONAL OFFICE.

.01 Where issues arise in a District Director's office with respect to matters within the contemplation of section 2.01 hereof and the District Director does not refer such issues to the National Office, as provided for in section 4 hereof, the taxpayer concerned may request National Office consideration under the circumstances described below.

.02 Requests for National Office consideration will be entertained upon a clear showing:

(a) That the position of the field office is contrary to the law or regulations on the points at issue;

(b) That the position of the field office is contrary to the position of the Internal Revenue Service as set forth in a published ruling currently in effect;

(c) That the position of the field office is contrary to a court decision which is followed by the Service, *i. e.*, acquiescence in an adverse Tax Court Decision;

(d) That the contemplated field action is in conflict with a determination made in a similar case in the same or another district; or

(e) That the issues arise because of unique or novel facts which had not previously been passed upon, as indicated by published rulings or announcements.

.03 The request for National Office consideration is to contain the information called for in Exhibit "C" hereof. A notice of intention that National Office consideration will be requested is to be filed with the District Director's office where the case is pending. This will consist of a copy of the request which is intended for National Office filing. If an adverse determination is made in the District Director's office, or if no action is taken within 30 days after the filing of such notice, the request is to be filed with the National Office. A determination will then be made whether the case is to be considered at the National Office and the taxpayer will be advised as to such determination. If the determination is to consider the case, the file will be called in from the field office. The taxpayer will then be afforded an opportunity to furnish a brief or memorandum on the points at issue and indicate whether a conference in Washington is desired or whether a determination is to be made on the written submission only. Copies of all written submissions are to be furnished the District Director. The District Director may submit a rebuttal memorandum to the National Office. If a conference is requested, a time and place will be set and the taxpayer advised. The taxpayer

may be represented by a person who is enrolled to practice before the Department and duly authorized to appear on his behalf. A determination will be made after full consideration of all the facts presented, taxpayer's briefs or memoranda, District Director's rebuttal memoranda, and conference discussions. The case will then be returned to the field office for appropriate disposition in accordance with the National Office determination and the taxpayer will be notified through the National Office as to such determination.

SEC. 6. EFFECT ON OTHER DOCUMENTS.

.01 Revenue Ruling 32, C. B. 1953–1, 265, is superseded by this Revenue Procedure.

.02 Revenue Ruling 54–172, C. B. 1954–1, 394, is amended to conform sections 3.01, 4.04, 7.02, and 7.03 thereof with this Revenue Procedure.

SEC. 7. EFFECTIVE DATE.

The effective date of this Revenue Procedure is May 21, 1956.

EXHIBIT "A"

Information to be filed with request for determination letter in connection with termination or curtailment of employees' plans and trusts.

1. The date as of which the plan (is proposed to be) terminated or curtailed.

2. A statement setting forth the reasons and circumstances relative to the (proposed) termination or curtailment.

3. A tabulation in columnary form showing the information specified below with respect to each of the twenty-five highest paid employees at the time of termination or curtailment (or, in case of a proposed termination or curtailment at the most recent anniversary of the plan) listed in the order of their compensation, and for all other employees as a group (showing the number in such group), covered by the plan:

(a) Name.
(b) Whether an officer.
(c) Percentage of each class of stock owned directly or indirectly by the employee or members of his family.
(d) Data, separately for the year in which the plan is terminated or curtailed and for each of the preceding years of the plan's operation (not in excess of 5, unless requested) with respect to:
    (i) Total compensation, other than deferred compensation.
    (ii) Employer's contribution.
    (iii) Employee's share in forfeitures.
    (iv) Employee's contributions.
(e) Totals for each of the columns under (d) above, for each year.
(f) Summary columns showing in aggregate (totalled horizontally) for all years, with respect to each of the employees listed and all others, data similar to the items called for under (d) above.

(g) A final column showing the total value of benefits distributed or to be distributed to each of the twenty-five highest paid employees and to all others.

4. A schedule, showing separately for the year in which the plan is terminated or curtailed and for each of the preceding years of the plan's operation (not in excess of 5, unless requested):

(a) The number of participants at the beginning of the period.
(b) The number added.
(c) The number who dropped out.
(d) The number remaining at the end of the period.

5. A statement as to whether any of the funds under the plan will revert to or become available to the employer; if so, details are to be furnished.

6. A statement with full particulars as to any funds under the plan which at any time were contributed in the form of or invested in obligations or property of the employer or related companies.

EXHIBIT "B"

Information to be filed with request for determination letter, or by way of notification, with respect to investment of trust funds in the stock or securities of the employer or controlled corporation.

1. Balance sheets of the employer (and controlled corporation if involved) as at the close of the last accounting period and for the taxable year ended prior thereto;
2. Comparative statements of income and profit and loss for the last and the four prior taxable years;

(The information called for under items 1 and 2 above, and item 6 below, and related data, may be submitted in composite form as set forth in Exhibit "B–1" hereof.)

3. An analysis of the surplus account for the last five years, specifically showing the amount and rate of dividends paid on each class of stock;
4. A statement accounting for all material changes from the latest dates of the aforesaid statements to the date of filing the information;
5. A schedule showing the nature and amounts of the various assets in the trust fund;
6. A statement setting forth the amount to be invested in the stock or securities of the employer (and controlled corporation if involved), the nature of the investment, the present rate of return, collateral or type of security for the loan if any, and the reasons for the investment.

EXHIBIT "B–1"

Composite schedule showing data called for under items 1, 2, and 6 of Exhibit "B"

1. Name and address of employer:
2. Name of plan:
3. District in which processed:
4. Date of favorable ruling or determination letter on qualification of plan:
5. Nature of investment:
6. Year of investment:
7. Amount of investment:
8. Annual yield:
9. Restrictions on marketability, if any:
10. Collateral, if any:
11. Total trust assets:
12. Total invested in Stock or Securities (including Promissory Notes) of employer (or controlled corporation):
13. Percentage of total assets invested (including current investment) in stock or securities of employer (and controlled corporation, if involved):
14. Nature of Employer's Business:
15. Reasons for the investment:

EMPLOYER'S FINANCIAL DATA

(And separately of controlled corporation, if involved)

16. Balance Sheets

	Latest year ended____	*Prior year ended____*
(a) Total current assets		
(b) Total current liabilities		
(c) Working capital [excess of (a) over (b)]		
(d) Current ratio [(a) divided by (b) to 1]		
(e) Total assets		
(f) Total liabilities		
(g) Capital		
(h) Analysis of capital:		
Preferred stock—Number of shares issued and outstanding		
Amount		
Common stock— Number of shares issued and outstanding		
Amount		
Surplus— Paid-in		
Earned		

17. Profit and loss

	Year ended__	*Year ended__*	*Year ended__*	*Year ended__*	*Year ended__*
(a) Net sales or total receipts					
(b) Cost of goods sold					
(c) Gross profit					
(d) Other Income					
(e) Total profit					
(f) Operating expenses					
(g) Other deductions					
(h) Net profit					

	Year ended__	*Year ended__*	*Year ended__*	*Year ended__*	*Year ended__*
(i) Federal income and excess profits taxes					
(j) Dividends paid					
(k) Other surplus charges					
(l) Surplus credits					
(m) Net transfer to surplus					

EXHIBIT "C"

Request for National Office consideration of issues in pension, annuity, profit-sharing, or stock bonus cases pending in District Directors' offices.

(Copy to District Director and original to National Office after adverse determination in field office, or the elapse of 30 days from date of filing of copy with District Director without action in field office)

1. Date of request.
2. Name and address of taxpayer.
3. Name and address of representative, if any (enrollment to practice before Department and authorization to appear required).
4. District Director's office in which case is pending.
5. Type of plan (pension, annuity, profit-sharing, or stock bonus).
6. Type of action involved (initial qualification, amendment, curtailment, termination, or investment).
7. Date of filing copy of this request with District Director.
8. Date and symbols of field determination letter, if any.
9. A succinct statement of the issues without presentation of the facts or argumentation, i. e., "Whether a limitation may be imposed on employer contributions used to provide benefits for stockholder-employees."
10. Grounds for requesting National Office consideration, i. e., field action contrary to law or regulations (sections involved), contrary to published rulings or court decisions (citations), conflict between districts or in same office (give name and district of case in conflict), or unique or novel facts (brief description).
11. State whether conference is desired at the National Office.
12. State whether the applicable information, as set forth in section 2.03 hereof, has been filed with the District Director.

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26 CFR 601.310: Forms. Rev. Proc. 56–13
(Also Part III–A, Sections 5008, 5061.)

The issuance of Form 2260, Monthly Report of Bottle Strip Stamps and Sheet Stamps, for use by proprietors in lieu of Forms 182, 1606, 1697, and part 8 of Form 45, is announced and its use by proprietors and insular revenue agents is discussed.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to announce the issuance of a new form, Form 2260, Monthly Report of Bottle Strip Stamps

and Sheet Stamps, for use by proprietors of registered distilleries, fruit distilleries, internal revenue bonded warehouses, taxpaid bottling houses, and rectifying plants, and by insular revenue agents.

SEC. 2. BACKGROUND.

Various regulations in Title 26 of the 1954 Code of Federal Regulations now require proprietors using strip stamps (except alcohol bottle stamps), distilled spirits excise tax stamps, or rectification tax stamps (for bottling tanks), to submit monthly reports regarding such stamps to Assistant Regional Commissioners, Alcohol and Tobacco Tax. Reports of strip stamps (except alcohol bottle stamps) are submitted on Form 182, Storekeeper-Gauger's Monthly Record and Report of Red Strip Stamps, and Form 1606, Monthly Record and Report of Bottled-in-Bond Stamps, both of which were originally designed for use by internal revenue officers. Reports of distilled spirits excise tax stamps are submitted on Form 1697, Report of Distilled Spirits Stamps. Reports of rectification tax stamps (for bottling tanks) are submitted on part 8 of Form 45, Rectifier's Monthly Record and Report. As the responsibility for accounting for all strip stamps (except alcohol bottle stamps), as well as distilled spirits excise tax stamps and rectification tax stamps (for bottling tanks), now rests with proprietors using such stamps, it has been determined that a single report form should be provided for use by such proprietors.

SEC. 3. INTERIM PROCEDURE.

The regulations which provide for the reporting of stamps on Forms 182, 1606, and 1697, and on part 8 of Form 45, are now being revised to provide instead for the use of Form 2260. These are the Regulations relating to the Production of Distilled Spirits, the Production of Brandy, the Warehousing of Distilled Spirits, the Bottling of Taxpaid Spirits, and the Rectification of Spirits and Wines. Form 2260 will be distributed as soon as it has been printed and should be used by proprietors, in lieu of part 8 of Form 45 or Form 182, 1606, or 1697, as soon as it becomes available.

SEC. 4. COMBINED USES OF FORM 2260.

A single Form 2260 may be used to report any of the stamps provided for on the form, but a separate page must be used for each type of bottle strip stamp. For example, while a warehouseman should report on one form domestic bottled-in-bond strip stamps and distilled spirits excise tax stamps, he should report export bottled-in-bond strip stamps on a separate page.

SEC. 5. INSULAR REVENUE AGENTS.

Section 250.146 of the Regulations relating to Liquors and Articles from Puerto Rico and the Virgin Islands provides that insular revenue agents in Puerto Rico having custody of red strip stamps will keep records of daily use of such stamps and submit monthly reports on Form 182. These regulations are being amended to provide that the insular revenue agents will keep memorandum records of daily use and will submit monthly reports on Form 2260, properly modified.

SEC. 6. ALCOHOL BOTTLE STAMPS.

Form 2260 is designed for use by proprietors in reporting alcohol bottle stamps. However, the Industrial Alcohol Regulations have

not been amended to transfer the custody of, and the accounting for, such stamps to the proprietors. Until the regulations are so amended, storekeeper-gaugers will continue to use Form 118, Storekeeper-Gauger's Monthly Record and Report of Alcohol Bottle Stamps, for reporting alcohol bottle stamps.

SEC. 7. INQUIRIES.

Inquiries in regard to this Revenue Procedure should refer to the number thereof and should be directed to the Assistant Regional Commissioner, Alcohol and Tobacco Tax.

SEC. 8. EFFECTIVE DATE.

This Revenue Procedure shall be effective April 24, 1956.

(Also Part III–A, Sections 5114, 5285; 230.280, 235.815.) Rev. Proc. 56–14

The separate reporting of products dumped or rectified, where such products are to be bottled or packaged especially for export with benefit of drawback, is no longer required. Information regarding reduced reporting requirements on Form 45, Rectifier's Monthly Record and Report, and Form 52–D, Monthly Record and Report of Taxpaid Bottling House Operations, in respect thereto is provided.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to provide information regarding reduced requirements for the reporting, on Form 45, Rectifier's Monthly Record and Report, and on Form 52–D, Monthly Record and Report of Taxpaid Bottling House Operations, of distilled spirits or wines bottled or packaged especially for export with benefit of drawback.

SEC. 2. REQUIREMENTS OF REGULATIONS.

The Regulations relating to Drawback on Liquors Exported no longer require a declaration of intent to bottle or package distilled spirits or wines especially for export with benefit of drawback. Accordingly, certain reporting requirements of Forms 45 and 52–D are no longer applicable.

SEC. 3. REPORTING ON FORMS 45 AND 52–D.

.01 As a result of the changed requirements, the totals of all products dumped, as reported in Form 45, part 7, columns 1 through 9, lines 1 through 14, and in Form 52–D, part 5, columns 1 through 6, lines 1 through 12 and 14, 15, and 16, should include all products dumped which are to be ultimately bottled or packaged for export or for domestic purposes. The information formerly required to be reported in Form 45, part 7, columns 1 through 9, at line 15, and in Form 52–D, part 5, columns 1 through 6, at lines 13 and 17, is eliminated.

.02 The preparation of a separate part 4 of Form 45 or part 2 of Form 52–D, covering the dumping of spirits or wines for packaging for export, is no longer necessary and products packaged for export should be identified and reported in part 4 of Form 45 or part 2 of Form 52–D prepared to cover all dumps for both bottling or packag-

ing whether or not the products are to be exported. Bottled export items should be identified by the legend "Exp" and packaged export items by the legend "Exp Pkg." In order that such packaged products might continue to appear as separate items in the summary (part 6 of Form 45 or part 4 of Form 52–D), the totals of products packaged for export should be reported, with appropriate identification, in Form 45, part 6, at new lines 25½, 26½, 45½, and 48½, or in Form 52–D, part 4, at new lines 14½, 15½, 30½, and 31½.

SEC. 4. INQUIRIES.

Inquiries in respect to this Revenue Procedure should refer to the number thereof and should be addressed to the Assistant Regional Commission, Alcohol and Tobacco Tax.

SEC. 5. EFFECTIVE DATE.

This Revenue Procedure is effective April 13, 1956.

(Also Part III–A, Section 5386; Section 240.445.) Rev. Proc. 56–15

Essences listed as ingredients in special natural wine must be adequately identified on Form 698–Supplemental, Formulas and Process for Wine.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to provide certain information as an aid in the adequate and uniform identification of essences on Forms 698–Supplemental, Formulas and Process for Wine, on submission to the National Office.

SEC. 2. BACKGROUND.

The Wine Regulations provide for the identification of essences on Forms 698–Supplemental on submission by proprietors of bonded wine cellars. In a number of instances, action on these forms in the National Office has been delayed due to inadequate identification of essences thereon.

SEC. 3. IDENTIFICATION OF ESSENCE.

.01 Where a natural essence or flavor to be used in the production of special natural wine is a product which has been manufactured under a formula approved pursuant to the Regulations relating to Drawback on Distilled Spirits Used in Manufacturing Nonbeverage Products, the formula filed on Form 1678, Formula and Process for Nonbeverage Product, will be considered as satisfying the requirement of section 240.447 of the Wine Regulations for the filing of a sample and a statement of materials and processes. In such case, the formula number (Form 1678) under which approved, the date of approval, and the name of the manufacturer should be shown on Form 698–Supplemental covering the special natural wine.

.02 To provide permanent instructions relative to the submission of identifying information of essences used in special natural wines, Form 698—Supplemental is being revised to include specific information in the instructions on the form in regard to the identifying information required.

.03. Assistant Regional Commissioners, Alcohol and Tobacco Tax, will examine the forms prior to submission to the National Office and, where such forms list as an ingredient an essence which is not sufficiently identified, they will be returned to the proprietor of the bonded wine cellar for correction.

SEC. 4. INQUIRIES.

Any inquiries with respect to this Revenue Procedure should refer to the number thereof and should be directed to the Assistant Regional Commissioner, Alcohol and Tobacco Tax.

SEC. 5. EFFECTIVE DATE.

This Revenue Procedure shall be effective April 26, 1956.

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26 CFR 601.318: Forms. Rev. Proc. 56–16
(Also Part I, Section 5703; Section 270.148.)

Instructions are issued for the preparation and distribution, by manufacturers of large cigars, of Form 168, Order for Stamps for Large Cigars, revised February 1956.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to provide instructions relative to the preparation of revised Form 168, Order for Stamps for Large Cigars.

SEC. 2. REVISION OF FORM 168.

The order for stamps, Form 168, required to be prepared by manufacturers in ordering stamps for large cigars, has been revised by changing "Factory No." to "Permit No." and by inserting in the instructions the sentence, "This form shall be executed in triplicate." Existing stocks of Form 168 (Revised March 1953) may continue to be used and will continue to be issued for use until exhausted.

SEC. 3. PREPARATION OF FORM 168 BY MANUFACTURERS.

The Form 168 will be prepared in triplicate and will show the manufacturer's permit number.

SEC. 4. PROCEDURE.

The manufacturer of large cigars will present the three copies of Form 168, which must be accompanied by remittance in the full amount, to the District Director of Internal Revenue, who will stamp such order "Received with Remittance," as provided in Revenue Procedure 56–1, page 1016, this Bulletin, and will return one copy of the receipted form to the manufacturer. In accordance with section 270.148(b) of the Regulations relating to Cigars and Cigarettes (Manufacturers, Importers, and Dealers), the manufacturer must retain a copy of each such order form, which has been marked paid by the District Director of Internal Revenue, for two years following the close of the year in which the stamps were purchased, and such form shall be made available for inspection by any internal revenue officer upon his request.

SEC. 5. INQUIRIES.

Inquiries in regard to this Revenue Procedure should refer to the number thereof and should be directed to the Assistant Regional Commissioner, Alcohol and Tobacco Tax.

SEC. 6. EFFECTIVE DATE.

This Revenue Procedure is effective April 4, 1956.

(Also Part I, Section 3401; 26 CFR 31.3401(a)–1.) Rev. Proc. 56–17

Employers may report excludable sick pay on Form W–2 under a special caption.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to set forth the conditions under which sick and injury payments excludable from gross income under section 105(d) of the Internal Revenue Code of 1954 may be shown separately on Form W–2, Withholding Tax Statement, reporting wages paid after December 31, 1955.

SEC. 2. BACKGROUND.

Section 31.3401(a)–1 of the Employment Tax Regulations is applicable to withholding of income tax on sick and injury payments made after December 31, 1955, under wage continuation plans. That section provides that all sick and injury payments excludable from gross income under section 105(d) of the Code, which are made directly by the employer, must be included in the amount of total wages reported on Form W–2, but the section is silent with respect to any mandatory or permissive rules for showing separately such excludable amounts on Form W–2. A number of inquiries have been received whether these excludable amounts may be reported separately on Form W–2.

SEC. 3. PROCEDURE.

Employers may show separately on Form W–2 the amount of any sick or injury payments excludable from gross income, under section 105(d) of the Code, which are made directly by them. However, in such cases, regardless of whether or not tax was withheld on such excludable amounts, employers must keep the records described by subdivisions (1) and (2) of section 31.3401(a)–1(b)(8)(ii)(b) of the regulations. If these excludable amounts are reported separately on Form W–2, the entry should be placed under a special caption, "Excludable Sick Pay." It should be clearly understood that, whether or not a separate entry is made of the amount excludable from gross income under section 105(d) of the Code, the employer must include this amount in the total wages reported on Form W–2.

SEC. 4. EMPLOYEE'S STATEMENT FOR INCOME TAX RETURN.

The fact that "Excludable Sick Pay" (or a similar entry) may be reported separately on Form W–2 will not relieve the employee of the necessity of submitting the statement which is required to be attached to his individual income tax return showing the computation

of "Excludable Sick Pay" and indicating the period or periods of absence, nature of illness or injury, and whether hospitalized.

SEC. 5. EFFECTIVE DATE.

This Revenue Procedure is effective immediately.

Rev. Proc. 56–18

The International Operations Division is transferred, effective May 1, 1956, from the Baltimore District, Philadelphia Region, to the National Office, Washington, D. C.

SECTION 1. PURPOSE

The purpose of this Revenue Procedure is to announce the transfer of the International Operations Division from the Baltimore District, Philadelphia Region, to the Natioinal Office, Washington, D. C.

SEC. 2. TRANSFER

The International Operations Division has been transferred, effective May 1, 1956, from the Baltimore District, Philadelphia Region, to the Office of the Assistant Commissioner (Operations) in the National Office, Washington, D. C., and the Director of International Operations shall report, on and after that date, to the Assistant Commissioner (Operations).

SEC. 3. EFFECT ON OTHER DOCUMENTS

This Revenue Procedure amends Commissioner's Reorganization Order No. 15, C. B. 1953–2, 505, and Revenue Procedure 55–2, C. B. 1955–2, 898. Any other internal management documents, the provisions of which are inconsistent or in conflict with the provisions of this Revenue Procedure, are hereby amended or superseded accordingly.

SEC. 4. EFFECTIVE DATE

This Revenue Procedure is effective May 1, 1956.

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26 CFR 601.301: Imposition of taxes, qualification requirements, and regulations. (Also Part III–A, Section 7805; Section 220.489.)

Rev. Proc. 56–19

Explanation of permissible and prohibited dispositions and uses of distilled spirits samples and remnants thereof withdrawn by proprietors of distilleries, internal revenue bonded warehouses, and bonded wine cellars.

SECTION 1. PURPOSE.

This Revenue Procedure is issued to clarify and emphasize the permissible and prohibited uses and disposition of samples of distilled spirits withdrawn by proprietors from distilleries, internal revenue bonded warehouses, and bonded wine cellars.

SEC. 2. BACKGROUND.

Pursuant to the Regulations relating to (1) the Production of Distilled Spirits, (2) the Production of Brandy, (3) the Warehousing

of Distilled Spirits, and (4) Wine (26 CFR, Parts 220, 221, 225, and 240, respectively), samples of distilled spirits may be obtained for the purposes specified in such regulations. These regulations also prescribe the disposition which shall be made of unused portions of samples. As it has come to the attention of the National Office that requirements relating to permissible uses of samples, and proper disposition of unused portions of samples, are not fully understood, it is desired to clarify these requirements.

SEC. 3. PERMISSIBLE USES.

Except in the case of samples withdrawn subject to tax, all samples of distilled spirits withdrawn by proprietors from distilleries, internal revenue bonded warehouses, and bonded wine cellars must be used solely for laboratory analysis or testing (including organoleptic examination). See Revenue Ruling 55–493, C. B. 1955–2, 730, which provides, in part, that samples removed from internal revenue bonded warehouses for any purpose other than organoleptic examination or laboratory analysis, regardless of size or number, must be taxpaid. It is intended that such analyses and tests shall consists of determinations of the kind and quantity of the components of the spirits or of the intrinsic properties or characteristics (taste, odor, color, specific gravity, water solubility, etc.) of the spirits.

SEC. 4. USES NOT PERMITTED.

Under no circumstances shall any samples withdrawn for laboratory analysis or testing (including organoleptic examination) be used for sale or consumption or be furnished to prospective buyers, salesmen, or dealers for advertising or soliciting purposes. Unless the label affixed to the sample container at the time of withdrawal bears the words "Subject to Tax," samples withdrawn for laboratory analysis or testing (including organoleptic examination) shall not be used for any of the following purposes:

(1) For the development of blends.

(2) For testing the stability or suitability of newly developed materials used in the manufacture of containers, closures, pipes, hoses, etc.

(3) For furnishing to a purchaser of spirits, if the sample is not to be used as provided in section 3, notwithstanding the spirits have been sold subject to the purchaser's approval.

(4) For use solely as a laboratory standard or "library sample."

This is not intended to be a complete listing.

SEC. 5. DISPOSITION OF REMNANTS.

Samples withdrawn for the uses described in section 3 should be kept in a place of security. Remnants of such samples, if they are desired for use as laboratory specimens or in further analysis or testing, should likewise be safeguarded. When no longer needed as specimens or samples, such remnants should be disposed of by one or more of the methods listed below and no other:

(1) Complete destruction by pouring into a sewer or by some other equally effective means.

(2) Pouring into vessels in a distilling system on distillery premises under the supervision of a storekeeper-gauger.

(3) Return to the bonded wine cellar for use in the production of wine (where the remnants are of samples of wine spirits withdrawn from a bonded wine cellar).

SEC. 6. EXISTING PROCEDURE.

Prompt correction should be made of any procedure or instruction in conflict with the provisions of this Revenue Procedure.

SEC. 7. INQUIRIES.

Inquiries in regard to this Revenue Procedure should refer to the number thereof and should be directed to the Assistant Regional Commissioner, Alcohol and Tobacco Tax.

SEC. 8. EFFECTIVE DATE.

This Revenue Procedure shall be effective May 4, 1956.

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26 CFR 601.313: Collection of taxes. (Also Part I, Section 5703; 275.137.) Rev. Proc. 56-20

A new 22-ounce denomination internal revenue manufactured tobacco tax stamp for use in payment of tax on manufactured tobacco has been authorized.

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to advise that a new 22-ounce denomination internal revenue tobacco tax stamp, $1\frac{3}{16}$ inches wide and $3\frac{5}{8}$ inches in length, for use in payment of tax on manufactured tobacco, has been recently authorized.

SEC. 2. INSTRUCTIONS.

Manufacturers and importers of manufactured tobacco desiring to use the new 22-ounce denomination internal revenue tobacco tax stamps may purchase them after May 15, 1956, from District Directors of Internal Revenue in the same manner as other tobacco tax stamps.

SEC. 3. INQUIRIES.

Inquiries in regard to this Revenue Procedure should refer to the number thereof and should be directed to the appropriate Assistant Regional Commissioner, Alcohol and Tobacco Tax.

ANNOUNCEMENT OF THE DISBARMENT AND SUSPENSION OF ATTORNEYS AND AGENTS FROM PRACTICE BEFORE THE TREASURY DEPARTMENT

Under section 261, Title 5 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from further practice before the Treasury Department any person, agent, or attorney shown to be incompetent, disreputable, or who refuses to comply with rules and regulations governing the recognition of agents, attorneys, or other persons representing clients before the Treasury Department, or who in any manner has wilfully and knowingly deceived, misled, or threatened any client or prospective client by word, circular, letter, or advertisement. Enrolled persons are prohibited in any Treasury Department matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any person disbarred or under suspension from practice before the Treasury Department. To enable enrolled persons to identify such disbarred or suspended persons, the Internal Revenue Service will announce in the Internal Revenue Bulletin the names and addresses of persons who have been disbarred or suspended from such practice, their designation as attorney, agent, or other representative, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletins at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for a period of 2 months for each agent and attorney so suspended or disbarred and will later be consolidated and published in the Cumulative Bulletin.

The following persons, after due notice and opportunity of hearings, have been disbarred from further practice before the Treasury Department:

Name	Address	Designation	Date of disbarment
DeCarlo, Charles L	Miami, Fla	Attorney	Dec. 15, 1955
Hardin, M. Guy, Sr	St. Louis, Mo	Agent	Mar. 12, 1956
Koritz, Alford A	Valparaiso, Ind	Attorney	Dec. 12, 1955
Manning, Leon M	Ogden, Utah	Agent	Dec, 12, 1955
Schopick, Samuel	New Rochelle, N. Y.	Attorney	Feb. 28, 1956
Watson Lawrence E	Raleigh, N. C	Agent	Dec. 15, 1955

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