

# INCOME TAX REGULATIONS

## (REGULATIONS 118)

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### CODE OF FEDERAL REGULATIONS

#### TITLE 26—INTERNAL REVENUE

#### [1939]

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#### CHAPTER 1—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

#### SUBCHAPTER A—INCOME AND EXCESS PROFITS TAXES

#### PART 39—INCOME TAX: TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1951

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its stockholders, or both, are in control of a transferee corporation, it is not necessary that the stock be acquired on or after January 1, 1951. Thus, if Corporation F on June 1, 1950, owns 70 percent of the voting stock of Corporation G, and, thereafter, on January 2, 1952, Corporation F acquires an additional 10 percent of such stock, control within the meaning of section 15(c) is acquired by Corporation F on January 2, 1952.

(d) **Nature of transfer.** A transfer made by any corporation of all or part of its assets, whether or not such transfer qualifies as a reorganization under section 112(g), is within the scope of section 15(c), except that section 15(c) does not apply to a transfer of money only. For example, the transfer of cash for the purpose of expanding the business of the transferor corporation through the formation of a new corporation is not a transfer within the scope of section 15(c), irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property.

(e) **Purpose of transfer.** In determining, for the purpose of section 15(c), whether the securing of the exemption from surtax or the minimum excess profits credit constituted "a major purpose" of the transfer, all circumstances relevant to the transfer shall be considered. For disallowance of the surtax exemption and minimum excess profits credit under section 15(c), it is

not necessary that the obtaining of either such credit or exemption or both have been the sole or principal purpose of the transfer of the property. It is sufficient if it appears, in the light of all the facts and circumstances, that the obtaining of such exemption or credit, or both, was one of the major considerations that prompted the transfer. Thus, the securing of the surtax exemption or the minimum excess profits credit may constitute "a major purpose" of the transfer, notwithstanding that such transfer was effected for a valid business purpose and qualified as a reorganization within the meaning of section 112(g). The taxpayer's burden of establishing by the clear preponderance of the evidence that the securing of either such exemption or credit or both was not "a major purpose" of the transfer may be met, for example, by a showing that the obtaining of such exemption, or credit, or both, was not a major factor in relationship to the other consideration or considerations which prompted the transfer.

(f) **Taxable years to which applicable.** Section 15(c) and this section do not apply to any taxable year with respect to which the excess profits tax imposed by subchapter D of chapter 1 of the Internal Revenue Code is not in effect. For treatment of taxable years beginning before April 1, 1954, and ending after March 31, 1954, see § 39.108-2. For computation of the excess profits tax for certain fiscal years, see § 40.430-2(b) (2) and (c) of Regulations 130 (Part 40 of this chapter).

### COMPUTATION OF NET INCOME

§ 39.21 [Comprises Code section 21, see 26 U.S.C.A. § 21]

#### § 39.21-1 Meaning of net income

(a) The tax imposed by chapter 1 is upon income. Neither income exempted by statute or fundamental law, nor expenses incurred in connection therewith, other than interest, enter into the computation of net income as defined

by section 21. (See section 24 (a) (5).) In the computation of the tax various classes of income must be considered:

(1) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived

from the sale or other disposition of capital assets. Cash receipts alone do not always accurately reflect income, for the Internal Revenue Code recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. (See sections 22, 23, 24, and 117.)

(2) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by chapter 1. (See section 22.)

(3) Net income, meaning gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. (See sections 23 and 24.)

(4) Net income less certain credits. (See sections 25, 26, 27, and 28.)

(b) The normal taxes and surtaxes imposed on individuals and on corporations are computed upon net income less certain credits. Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications, statutory net income is commercial net income. This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer. (See section 41.)

(c) The net income of corporations is determined in general in the same manner as the net income of individuals, but the deductions allowed corporations are not precisely the same as those allowed individuals. (See sections 23, 24, 102, 118, 121, 122, 203, 204, 207, 232, and 336, and sections 500 to 511, inclusive.)

§ 39.22 (a) [Comprises Code section 22 (a), see 26 U.S.C.A. § 22 (a)]

§ 39.22 (a)-1 What included in gross income

(a) Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. See sections 22(b) and 116. In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 238, inclusive, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or of property.

(b) If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of a distribution of earnings or profits taxable as a dividend. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock, as to which see § 39.22 (a)-8.

(c) Except as otherwise provided in section 130A, if property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. See section 130A and the regulations prescribed thereunder for special rules with respect to stock transferred from an employer to an employee pursuant to the timely exercise of a restricted stock option.

(d) The fact that a dividend is declared shortly after the sale of corporate stock and the sale price is influenced by the expectation of the payment of a dividend, does not make such dividend when paid taxable to the vendor as a dividend. The amount advanced by the vendee to the vendor in contemplation of the next dividend payment is an investment of capital and may not be claimed as a deduction from gross income.

(e) As to the amount of income tax paid for a bondholder by the obligor pursuant to a so-called tax-free covenant, see section 143 (a) (3). As to the determination of gain or loss from the sale or other disposition of property, see sections 111 to 113, inclusive. As to amounts received as loans from the Commodity Credit Corporation, see section 123. As to income upon a recovery in respect of war losses, see section 127 (c). As to insurance companies and foreign corporations, see sections 201 to 207, inclusive, and section 231.

**§ 39.22 (a)-2 Compensation for personal services**

(a) Commissions paid salesmen, compensation for services on the basis

of a percentage of profits, commissions on insurance premiums, tips, pay of persons in the military or naval forces of the United States, retired pay of Federal and other officers, and pensions or retiring allowances paid by the United States (unless expressly exempt) or by private persons are income to the recipients; as are also marriage fees, baptismal offerings, sums paid for saying masses for the dead, and other contributions received by a clergyman, evangelist, or religious worker for services rendered. However, so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable.

(b) The salaries of Federal officers and employees are subject to tax. Amounts deducted and withheld pursuant to the Civil Service Retirement Act of May 29, 1930 [5 U.S.C.A. § 691 et seq.] from the basic salary, pay, or compensation of the employees in the civil service of the United States are includible in gross income for the year in which deducted and withheld. As used in this section, the term "Federal officers and employees" includes all judges of courts of the United States irrespective of when they took office. Compensation received for services rendered as an officer or employee (including a member of a legislative body and a judge or officer of a court) of a State or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing, is to be included in gross income, regardless of the nature of the office or employment.

(c) The value of services need not be included in gross income when rendered directly and gratuitously to an organization described in section 23(o). Where, however, pursuant to an agreement or understanding services are rendered to a person for the benefit of an organization described in section 23 (o) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid constitutes income to the person performing the services even though at the time of the agreement or understanding the person mak-

(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 under subchapter D of chapter 9. The credit with respect to a special refund is not allowable unless the return, amended return, or claim for refund, on which the special refund is claimed, is filed within two years after the calendar year in which payment is made of the wages with respect to which the special refund of tax is claimed. See section 1401(d) (3) and (4) and § 408.802(c) of this chapter (Regulations 128) pertaining to tax under subchapter A of chapter 9 (Federal Insurance Contributions Act). For special provisions for claiming special refunds in the case of employees not required to file income tax returns, see § 408.802(c) (3) of this chapter (Regulations 128).

(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 subchapter D of chapter 9. If the amount of such special refund when added to amounts deducted and withheld as income tax under subchapter D of chapter 9 exceeds the taxes imposed by chapter 1, the amount of the excess constitutes an overpayment of income tax under chapter 1, and interest on such overpayment is allowed to the extent provided under section 3771 upon an overpayment of income tax resulting from a credit for income tax withheld at source. See section 322(a) (2) and (4).

(b) **Federal and State employees.** The provisions of this section shall apply to the amount of a special refund (under section 1401(d) (4) (A)) allowable to an employee of a Federal agency or a wholly owned instrumentality of the United States, and to the amount of a special refund (under section 1401(d) (4) (B)) allowable to an employee of any State or political subdivision thereof (or any instrumentality of any one or more of the foregoing).

## ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

§ 39.41 [Comprises Code section 41, see 26 U.S.C.A. § 41]

### § 39.41-1 Computation of net income

Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any

item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

Internal Revenue Code references are identical with 26 U.S.C.A. (I.R.C. 1939) sections

**§ 39.41-2 Bases of computation and changes in accounting methods**

(a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 39.42-2 and 39.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 39.22 (c)-5.)

(b) The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 39.22(c)-1 to 39.22 (c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 39.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 39.22(a)-7 and 39.23(a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See section 22(d) and §§ 39.22(d)-1 to 39.22(d)-7, inclusive, with respect to changing to the last-in first-out method of inventorying goods.

(d) Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

(e) The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires