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PART I

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Agricultural Stabilization and Conservation Service
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Atomic Energy Commission
Civil Aeronautics Board
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Consumer and Marketing Service
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Title 26—INTERNAL REVENUE

Chapter I—Internal Revenue Service, Department of the Treasury

SUBCHAPTER A—INCOME TAX

[T. D. 6885]

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Income Averaging

On April 9, 1965, notice of proposed rule making with respect to the amendment of the Income Tax Regulations (26 CFR Part 1) under sections 1301 through 1305 of the Internal Revenue Code of 1954 (relating to income averaging) and certain other conforming changes was published in the FEDERAL REGISTER (30 F.R. 4619). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the amendment of the regulations as proposed is hereby adopted subject to the changes set forth below:

PARAGRAPH 1. Section 1.1302–2, as set forth in paragraph 1 of the appendix to the notice of proposed rule making, is amended by revising subparagraphs (1) (ii) and (3) (ii) (b) of paragraph (c) and paragraph (f).

PAR. 2. Section 1.1304–2, as set forth in paragraph 1 of the appendix to the notice of proposed rule making, is amended by revising paragraph (a) (1) and (4).

PAR. 3. Section 1.1304–3, as set forth in paragraph 1 of the appendix to the notice of proposed rule making, is amended by revising paragraph (e).

[SEAL] SHELDON S. COHEN,
Commissioner of Internal Revenue.

Approved: May 24, 1966.

STANLEY S. SURREY,
Assistant Secretary of the Treasury.

In order to conform the Income Tax Regulations (26 CFR Part 1) to the amendments made to part I, subchapter Q, chapter 1 of the Internal Revenue Code of 1954 by section 232(a) of the Revenue Act of 1964 (78 Stat. 105); to redesignate and amend the regulations under sections 1301 through 1307 of the Internal Revenue Code of 1954, as in effect prior to the enactment of the Revenue Act of 1964; and to make certain other changes, such regulations are amended as follows:

INCOME AVERAGING

Sec.
1.1301 Statutory provisions; limitation on tax.
1.1301–1 Limitation on tax.
1.1302 Statutory provisions; definition of averagable income; related definitions.
1.1302–1 Definition of averagable income.
1.1302–2 Adjusted taxable income.
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1.1303 Statutory provisions; eligible individuals.
1.1303–1 Eligible individuals.
1.1304 Statutory provisions; special rules.
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1.1304–2 Provisions inapplicable if income averaging is chosen.
1.1304–3 Special rules for computing base period income.
1.1304–4 Dollar limitations in case of joint returns.
1.1304–5 Determination of total tax for the computation year.
1.1304–6 Special rule for computation of alternative tax.
1.1304–7 Short taxable years.
1.1305 Statutory provisions; regulations.

AUTHORITY: The provisions of §§ 1.301 to 1.1305 issued under sec. 7805 of the Internal Revenue Code of 1954; 68A Stat. 917; 26 U.S.C. 7805.

PARAGRAPH 1. The following new center heading and regulations are inserted following the heading "Readjustment of Tax Between Years and Special Limitations":

INCOME AVERAGING

§ 1.1301 Statutory provisions; limitation on tax.

Sec. 1301. *Limitation on tax.* If an eligible individual has averagable income for the computation year, and if the amount of such income exceeds $3,000, then the tax imposed by section 1 for the computation year which is attributable to averagable income shall be five times the increase in tax under such section which would result from adding 20 percent of such income to the sum of—

(1) 133⅓ percent of average base period income, and

(2) The amount (if any) of the average base period capital gain net income.

[Sec. 1301 as amended by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

§ 1.1301–1 Limitation on tax.

If, for a taxable year beginning after December 31, 1963, an eligible individual (as defined in section 1303 and § 1.1303–1) has averagable income (as defined in section 1302(a) and § 1.1302–1) for the computation year (as defined in section 1302(e)(1) and § 1.1302–5), and if the amount of his averagable income exceeds $3,000, then such individual may choose (pursuant to the provisions of section 1304(a) and § 1.1304–1) to compute the tax attributable to his averagable income under section 1301. The tax imposed by section 1 of the Code which is attributable to an individual's averagable income for the computation year is the amount of tax equal to five times the increase in tax under section 1 which would result from adding 20 percent of the averagable income to the sum of—

(a) 133⅓ percent of the individual's average base period income (as defined in section 1302(c) and § 1.1302–3), and

(b) The amount (if any) of the individual's average base period capital gain net income (as defined in section 1302 (d)(2) and paragraph (b) of § 1.1302–4).

§ 1.1302 Statutory provisions; definition of averagable income; related definitions.

Sec. 1302. *Definition of averagable income; related definitions*—(a) *Averagable income.* For purposes of this part—

(1) *In general.* The term "averagable income" means the amount (if any) by which adjusted taxable income exceeds 133⅓ percent of average base period income.

(2) *Adjustment in certain cases for capital gains.* If—

(A) The average base period capital gain net income, exceeds

(B) The capital gain net income for the computation year,

then the term "averagable income" means the amount determined under paragraph (1), reduced by an amount equal to such excess.

(b) *Adjusted taxable income.* For purposes of this part, the term "adjusted taxable income" means the taxable income for the computation year, decreased by the sum of the following amounts:

(1) *Capital gain net income for the computation year.* The amount (if any) of the capital gain net income for the computation year.

(2) *Income attributable to gifts, bequests, etc.*—(A) *In general.* The amount of net income attributable to an interest in property where such interest was received by the taxpayer as a gift, bequest, devise, or inheritance during the computation year or any base period year. This paragraph shall not apply to gifts, bequests, devises, or inheritances between husband and wife if they make a joint return, or if one of them makes a return as a surviving spouse (as defined in section 2(b)), for the computation year.

(B) *Amount of net income.* Unless the taxpayer otherwise establishes to the satisfaction of the Secretary or his delegate, the amount of net income for any taxable year attributable to an interest described in subparagraph (A) shall be deemed to be 6 percent of the fair market value of such interest (as determined in accordance with the provisions of chapter 11 or chapter 12, as the case may be).

(C) *Limitation.* This paragraph shall apply only if the sum of the net incomes attributable to interests described in subparagraph (A) exceeds $3,000.

(D) *Net income.* For purposes of this paragraph, the term "net income" means, with respect to any interest, the excess of—

(i) Items of gross income attributable to such interest, over

(ii) The deductions properly allocable to or chargeable against such items.

For purposes of computing such net income, capital gains and losses shall not be taken into account.

(3) *Wagering income.* The amount (if any) by which the gains from wagering transactions for the computation year exceed the losses from such transactions.

(4) *Certain amounts received by owner-employees.* The amount (if any) to which section 72(m)(5) (relating to penalties applicable to certain amounts received by owner-employees) applies.

(c) *Average base period income.* For purposes of this part—

(1) *In general.* The term "average base period income" means one-fourth of the sum of the base period incomes for the base period.

(2) *Base period income.* The base period income for any taxable year is the taxable income for such year first increased and then decreased (but not below zero) in the following order:

(A) Taxable income shall be increased by an amount equal to the excess of—

(i) The amount excluded from gross income under section 911 (relating to earned income from sources without the United States) and subpart D of part III of subchapter N (sec. 931 and following, relating to income from sources within possessions of the United States), over

(ii) The deductions which would have been properly allocable to or chargeable against such amount but for the exclusion of such amount from gross income.

(B) Taxable income shall be decreased by the capital gain net income.

(C) If the decrease provided by paragraph (2) of subsection (b) applies to the computation year, the taxable income shall be decreased under the rules of such paragraph (2) (other than the limitation contained in subparagraph (C) thereof).

(d) *Capital gain net income, etc.* For purposes of this part—

(1) *Capital gain net income.* The term "capital gain net income" means the amount equal to 50 percent of the excess of the net long-term capital gain over the net short-term capital loss.

(2) *Average base period capital gain net income.* The term "average base period capital gain net income" means one-fourth of the sum of the capital gain net incomes for the base period. For purposes of the preceding sentence, the capital gain net income for any base period year shall not exceed the base period income for such year computed without regard to subsection (c)(2)(B).

(e) *Other related definitions.* For purposes of this part—

(1) *Computation year.* The term "computation year" means the taxable year for which the taxpayer chooses the benefits of this part.

(2) *Base period.* The term "base period" means the 4 taxable years immediately preceding the computation year.

(3) *Base period year.* The term "base period year" means any of the 4 taxable years immediately preceding the computation year.

(4) *Joint return.* The term "joint return" means the return of a husband and wife made under section 6013.

[Sec. 1302 as amended by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

§ 1.1302–1 Definition of averagable income.

(a) Except as provided in section 1302(a)(2) and paragraph (b) of this section, the term "averagable income" means the amount (if any) by which adjusted taxable income (as defined in section 1302(b) and § 1.1302–2) for the computation year exceeds 133⅓ percent of average base period income (as defined in section 1302(c) and § 1.1302–3).

(b) If average base period capital gain net income exceeds capital gain net income for the computation year, then the term "averagable income" means the amount determined under section 1302(a)(1) and paragraph (a) of this section reduced by an amount equal to such excess. For example, if the amount of an individual's averagable income, determined under section 1302(a)(1) and paragraph (a) of this section, is $10,000, and his average base period capital gain net income is $5,000 while his capital gain net income for the computation year is only $3,000, then the amount of such individual's averagable income for the computation year is $8,000.

§ 1.1302–2 Adjusted taxable income.

(a) *Definition.* The term "adjusted taxable income" means taxable income for the computation year as modified in accordance with paragraphs (1), (2), (3), and (4) of section 1302(b), section 1304(c)(4)(B), and this section. Such term is used only for purposes of computing the tax under sections 1301 through 1305. It has no effect, for example, upon either the determination of a credit or a deduction based upon the income of the computation year or the amount of income to be taken into account in computing base period income if the computation year later becomes a base period year.

(b) *Capital gain net income for the computation year.* In determining adjusted taxable income, taxable income for the computation year is decreased by the amount (if any) of capital gain net income (as defined in section 1302(d)(1) and paragraph (a) of § 1.1302–4) for that year.

(c) *Income attributable to gifts, bequests, devises, or inheritances*—(1) *General rule.* (i) In determining adjusted taxable income, taxable income for the computation year is decreased by the amount of net income attributable to an interest in property where such interest was received by the taxpayer as a gift, bequest, devise, or inheritance during the computation year or any base period year. Under the authority of sections 1302(b)(2) and 1305, this paragraph shall apply to any inter vivos or testamentary gift, including interests in property acquired from a 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). For example, the gratuitous beneficiary of a life insurance policy who receives the proceeds of the policy receives such proceeds as a gift, devise, bequest, or inheritance. The time when such an interest is received is determined in accordance with subparagraph (2) of this paragraph. Section 1302(b)(2) and this paragraph apply only if the total net income attributable to all such interests in property exceeds $3,000 in such year.

(ii) This paragraph shall not apply to the income attributable to interests in property transferred between husband and wife if, for the computation year, they make a joint return (including a joint return filed by a survivor with his deceased spouse for the year of the death of such spouse), or if one of them makes a return as a surviving spouse (as defined in section 2(b) and § 1.2–2) with respect to the transferor. However, this paragraph is applicable to the amount of net income attributable to interests in property transferred between husband and wife if such interests were received by the transferor spouse from a third party in the computation year or any base period year as a gift, bequest, devise, or inheritance.

(2) *Date of receipt.* (i) For purposes of section 1302(b)(2) and this paragraph, an interest in property is received at the time an individual has a present right to such property or the income from such property. An individual has a present right to the income from property even though such right is subject to the discretion of a fiduciary. For example, under the terms of a trust created by A, the trustee may pay the net income to B, C, and D in such proportions and amounts as the trustee, in his absolute discretion, determines. The trustee is authorized to accumulate income and add such income to trust corpus. Although the rights of B, C, and D to receive income payments are subject to the discretion of a fiduciary, each will be treated as having received a gift of his proportionate share of the trust corpus at the time the trust is established.

(ii) An individual may receive, at various times, different interests in a single property. For example, if H purchases Blackacre but takes title to the property with W as a tenant by the entirety, W will be treated as having received a gift of an undivided 50-percent interest in Blackacre at the time of such purchase. If H predeceases W, she will be treated as having received, for purposes of section 1302(b)(2) and this paragraph, the balance of the property on the date of H's death. However, if W predeceases H, he will be treated as having received a gift of W's 50-percent interest in Blackacre.

(3) *Net income*—(i) *Definition.* For purposes of section 1302(b)(2) and this paragraph, the term "net income" means, with respect to any interest in property, the excess of items of gross income attributable to such interest over the deductions properly allocable to or chargeable against such items. The total amount of net income for any taxable year attributable to all of the interests in property which an individual must take into account under this paragraph is the sum of the amounts of net income or net loss attributable to each such interest for such year. However, for purposes of computations under this paragraph, capital gains and losses and the deductions allocable to such gains and losses are not taken into account in determining the amount of net income at-

tributable to any interest in property. Thus, in any case in which an interest in property (or the disposition of such an interest) to which section 1302(b)(2) and this paragraph apply gives rise to a capital gain or loss, neither the amount of such gain or loss or of any deduction allocable to such gain or loss is taken into account in determining the net income attributable to such interest in property.

(ii) *Amount of net income.* (*a*) The amount of net income for any taxable year attributable to an interest in property to which this paragraph applies shall be deemed to be 6 percent of the fair market value of such interest, as determined in accordance with the provisions of chapter 11 (relating to the estate tax) or chapter 12 (relating to the gift tax) of the Code, as the case may be, unless the taxpayer establishes the actual income attributable to such interest to the satisfaction of the district director. The fair market value of an interest in property shall be determined as of the date of its receipt. Six percent of the fair market value of an interest in property is a fixed amount. Such amount is not adjusted to reflect any subsequent increase or decrease in the fair market value of such interest or any increase or decrease in the amount of income actually arising from such interest.

(*b*) With respect to any computation year, the amount of net income attributable to each interest in property must be determined in the same manner for each of the 5 taxable years taken into account under the income averaging provisions. Thus, unless the taxpayer establishes the actual income attributable to an interest in property to the satisfaction of the district director for each of such 5 years, the amount of net income attributable to each such interest for each of such 5 years is deemed to be 6 percent of the fair market value of such interest.

(d) *Wagering income.* In determining adjusted taxable income, taxable income for the computation year is decreased by the amount (if any) by which the gains includible in gross income for the computation year which are attributable to wagering transactions exceed the deduction for wagering losses under section 165(d) and § 1.165–10 for such year.

(e) *Certain amounts received by owner-employees.* In determining adjusted taxable income, taxable income for the computation year is decreased by the amounts (if any), described in section 72(m)(5)(A), to which a penalty under section 72(m)(5) and paragraph (e) of § 1.72–17 is applicable.

(f) *Items subject to a limitation on tax.* If the amount of tax attributable to an item of taxable income is subject to a limitation, such as section 632 (relating to the sale of oil and gas properties) or section 1347 (relating to claims against the United States), then, in determining adjusted taxable income, taxable income for the computation year is decreased by such items. If the tax attributable to any amount of an accumulation distribution from a trust is determined under section 668 (relating to treatment of amounts deemed distributed in preceding years) as though such amount had been distributed in a preceding taxable year, then, in determining adjusted taxable income, taxable income for the computation year is decreased by such amount.

(g) *Community income attributable to services.* (1) Under section 1304(c)(4)(B), in determining adjusted taxable income in the case of a married taxpayer who makes a separate return for the computation year, taxable income for such year shall be decreased by the excess (if any) of amounts includible in such return which constitute earned income (within the meaning of section 911(b)) and are community income under community property laws over the amount of such income which would have been includible if such earned income did not constitute community income.

(2) This paragraph may be illustrated by the following example:

Example. The total income of a husband and wife for the computation year consists of $60,000 of community income attributable to personal services, $40,000 of which is earned by H. W makes a separate return for such year and reports gross income of $30,000, her share of the community income. W chooses the benefits of income averaging for such year. In determining her adjusted taxable income for such year, W's taxable income must be reduced by $10,000, the excess of the community income attributable to personal services includible in her return ($30,000) over the amount of such income from personal services which would have been reportable by her if such income did not constitute community income ($20,000). The additional $10,000 of W's income for such year (which results from the application of local community property laws) is not subject to income averaging. For tax on such amounts, see paragraph (b) of § 1.1304–5.

§ 1.1302–3 Average base period income.

(a) *Definition.* The term "average base period income" means one-fourth of the sum of an individual's base period income for the base period. The term "base period" means the 4 taxable years immediately preceding the computation year.

(b) *Base period income*—(1) *Definition.* Except as otherwise provided in subparagraph (3) of this paragraph, the term "base period income" means taxable income for any base period year first increased in accordance with subparagraph (A) of section 1302(c)(2), and this section, and then decreased in accordance with subparagraphs (B) and (C) of section 1302(c)(2) and this section. Base period income for any taxable year may never be less than zero.

(2) *Base period income with respect to a computation year.* Base period income for each base period year must be determined in a manner consistent with the return for the computation year. The base period income with respect to a computation year for which an individual makes a separate return is the separate base period income of such individual. The base period income with respect to a computation year for which a husband and wife make a joint return is the sum of the base period incomes of both the husband and wife. Thus, if A and B, who were not married for the taxable years 1960–1963 and made separate returns for such years, marry in 1964 and make a joint return for the computation year 1964, their base period income for each of the taxable years 1960–1963 is the sum of the base period incomes for each such year of A (computed on the basis of his taxable income for each such year) and of B (similarly computed). If, however, they were married and made joint returns with each other for any of the base period years, their base period income for any such year may be computed on the basis of their aggregate taxable income. The base period income with respect to a computation year for which an individual makes a return as a surviving spouse (as defined in section 2(b) and § 1.2–2) is the sum of the base period incomes of the surviving spouse and the decedent with respect to whom such return is made.

(3) *Minimum limitation on base period income.* For any base period year to which section 1304(c)(1) applies (generally where an individual's marital status is different from that in the computation year), the separate base period income of an individual may not be less than the minimum separate base period income for such year computed in accordance with section 1304(c)(2) and § 1.1304–3.

(c) *Adjustments to taxable income*—(1) *Foreign and possessions income.* In determining base period income for any taxable year, taxable income for such year shall be increased by an amount equal to the excess of the amount of income which was excluded from gross income under section 911 (relating to earned income from sources without the United States) and subpart D of part III of subchapter N (sec. 931 and following, relating to income from sources within possessions of the United States) over the deductions which would have been properly allocable to or chargeable against such amount but for the exclusion of such amount from gross income.

(2) *Capital gain net income.* In determining base period income for any taxable year, taxable income for such year shall be decreased by the amount of capital gain net income (as defined in section 1302(d)(1) and paragraph (a) of § 1.1302–4) for such year. Section 1304(c)(3) and paragraph (f) of § 1.1304–3, relating to minimum base period capital gain net income, do not apply to the adjustment under this subparagraph.

(3) *Income attributable to gifts, bequests, devises, or inheritances.* If the decrease provided by section 1302(b)(2) and paragraph (c) of § 1.1302–2 is applicable to the computation year, then, in determining base period income for any taxable year, taxable income for such year shall be decreased under the rules of section 1302(b)(2) and paragraph (c) of § 1.1302–2. The limitation contained in section 1302(b)(2)(C) and paragraph (c)(1)(i) of § 1.1302–2 shall not apply to a base period year. For example, if an individual's taxable income for the computation year includes an amount of net

income attributable to gifts, bequests, devises, or inheritances which is in excess of $3,000, then, in determining base period income for his base period years, his taxable income for each such year must be decreased by any amount of net income so attributable to such property, whether or not in excess of $3,000. However, no adjustment to taxable income for a base period year shall be made under this subparagraph for a net loss.

§ 1.1302–4 Capital gain net income.

(a) *Capital gain net income.* The term "capital gain net income" means the amount, for any taxable year, equal to 50 percent of the excess of the net long-term capital gain (as defined in section 1222(7)) for such year over the net short-term capital loss (as defined in section 1222(6)) for such year. For example, if, for the taxable year 1964, an individual has a long-term capital gain of $10,000, a short-term capital gain of $3,000, and a capital loss carryover to 1964 of $8,000, then such individual has a capital gain net income for such year of $2,500 ($10,000—($8,000—$3,000) x 50 percent). An individual's capital gain net income for any taxable year cannot be less than zero.

(b) *Average base period capital gain net income*—(1) *Definition.* The term "average base period capital gain net income" means the amount equal to one-fourth of the sum of the capital gain net incomes for the 4 base period years.

(2) *Limitations.* (i) For purposes of determining average base period capital gain net income, the amount of capital gain net income for any base period year shall not exceed the amount of base period income for such year, computed without reduction by capital gain net income for such year. For example, if an individual's base period income computed without reduction by his capital gain net income for the base period year is $1,000, and if the amount of his capital gain net income for such year is $4,000, then, for purposes of computing his average base period capital gain net income, his capital gain net income for such base period year is $1,000.

(ii) For purposes of determining average base period capital gain net income, capital gain net income for any base period year for which section 1304(c)(1) and paragraph (b)(3) of § 1.1302–3 apply shall not be less than the minimum capital gain net income for such year computed in accordance with section 1304(c)(3) and paragraph (b) of § 1.1304–3. However, the amount of capital gain net income shall not exceed the amount of such income computed under subdivision (i) of this subparagraph.

§ 1.1302–5 Other related definitions.

(a) *Computation year.* The term "computation year" means the taxable year for which an eligible individual chooses under section 1304(a) the benefits of income averaging.

(b) *Base period.* See paragraph (a) of § 1.1302–3 for definition of the term "base period."

(c) *Base period year.* The term "base period year" means any of the 4 taxable years immediately preceding the computation year.

(d) *Joint return.* The term "joint return" means the return of a husband and wife made under section 6013.

§ 1.1303 Statutory provisions; eligible individuals.

Sec. 1303. *Eligible individuals*—(a) *General rule.* Except as otherwise provided in this section, for purposes of this part the term "eligible individual" means any individual who is a citizen or resident of the United States throughout the computation year.

(b) *Nonresident alien individuals.* For purposes of this part, an individual shall not be an eligible individual for the computation year if, at any time during such year or the base period, such individual was a nonresident alien.

(c) *Individuals receiving support from others*—(1) *In general.* For purposes of this part, an individual shall not be an eligible individual for the computation year if, for any base period year, such individual (and his spouse) furnished less than one-half of his support.

(2) *Exceptions.* Paragraph (1) shall not apply to any computation year if—

(A) Such year ends after the individual attained age 25 and, during at least four of his taxable years beginning after he attained age 21 and ending with his computation year, he was not a full-time student,

(B) More than one-half of the individual's adjusted taxable income for the computation year is attributable to work performed by him in substantial part during two or more of the base period years, or

(C) The individual makes a joint return for the computation year and not more than 25 percent of the aggregate adjusted gross income of such individual and his spouse for the computation year is attributable to such individual.

In applying subparagraph (C), amounts which constitute earned income (within the meaning of section 911(b)) and are community income under community property laws applicable to such income shall be taken into account as if such amounts did not constitute community income.

(d) *Student defined.* For purposes of this section, the term "student" means, with respect to a taxable year, an individual who during each of 5 calendar months during such taxable year—

(1) Was a full-time student at an educational institution (as defined in section 151(e)(4); or

(2) Was pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution (as defined in section 151(e)(4) or of a State or political subdivision of a State.

[Sec. 1303 as amended by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

§ 1.1303–1 Eligible individuals.

(a) *General rule.* Except as otherwise provided in section 1303 and this section, the term "eligible individual" means any individual who is a citizen or resident of the United States throughout the computation year. Such term does not include an estate or trust. If a husband and wife make a joint return under section 6013 for the computation year, both the husband and the wife must be eligible individuals in order to choose the benefits of income averaging.

(b) *Nonresident alien individuals.* An individual is not an eligible individual for the computation year if, at any time during such year or his base period, he was a nonresident alien. The determination that an individual is a nonresident alien is made in accordance with § 1.871–2 through § 1.871–4. For example, if H, a United States citizen living abroad, married W, an alien, during 1960 and returned with her to live in the United States on December 31, 1962, they may not choose the benefits of income averaging if they file a joint return for the taxable year 1964 since W was a nonresident alien for three base period years (1960–1962). H, however, may make a separate return and may, if he is otherwise qualified, choose the benefits of income averaging.

(c) *Individuals receiving support from others*—(1) *Self-support rule.* Except as provided in section 1303(c)(2) and subparagraphs (2), (3), and (4) of this paragraph, to be an eligible individual for the computation year under this paragraph, an individual must, together with his spouse, have furnished 50 percent or more of his support during each of his 4 base period years. For example, H and W are married for the computation year and the 4 base period years. If H and W have provided more than 50 percent of their support during each of the 4 base period years, both H and W are eligible individuals for the computation year. For purposes of determining, under section 1303(c)(1) and this paragraph, whether or not an individual supplied, for a given taxable year, 50 percent or more of his support, the rules of section 152 and the regulations thereunder shall be applied.

(2) *Individuals over 25.* Notwithstanding the general rule contained in section 1303(c)(1) and subparagraph (1) of this paragraph, an individual may be an eligible individual for a computation year if—

(i) That year ends after the individual attained age 25, and

(ii) During at least four of his taxable years beginning after he attained age 21 and ending with the computation year, he was not a full-time student.

For the definition of the term "student" as used in this subparagraph, see paragraph (d)(1) of this section.

(3) *Major accomplishment rule.* Notwithstanding the general rule contained in section 1303(c)(1) and subparagraph (1) of this paragraph, an individual may be an eligible individual for a computation year if more than 50 percent of his adjusted taxable income for the computation year is attributable to work performed by him in substantial part during two or more of his four base period years. It is not necessary that the individual perform any of the work in his computation year.

(4) *Spouse supported by others.* (i) Notwithstanding the general rule contained in section 1303(c)(1) and subparagraph (1) of this paragraph, an individual may be an eligible individual for a computation year if—

(a) Such individual makes a joint return under section 6013 for such year, and

(b) Not more than 25 percent of the aggregate adjusted gross income of such individual and his spouse for such year is attributable to such individual.

For example, H and W, who are United States citizens and calendar year taxpayers, were married in August 1963. H supported himself from 1960 to 1964. W's parents furnished more than 50 percent of her support for each year prior to her marriage. For the taxable year 1964, H and W filed a joint return showing an aggregate adjusted gross income of $10,000, all of which is attributable to H. If H and W are otherwise qualified, they may choose the benefits of income averaging for 1964.

(ii) In applying this subparagraph, to determine the amount of the aggregate adjusted gross income of a husband and wife which is attributable to either of them, amounts of earned income which are community income under community property laws applicable to such income are taken into account as if such amounts did not constitute community income. For the definition of the term "earned income," see section 911(b) and paragraph (c) of § 1.911–2.

(d) *Definitions*—(1) *Student.* For purposes of section 1303 and this section, the term "student" means, with respect to a taxable year, an individual who during each of 5 calendar months during such taxable year was a full-time student at an educational institution or was pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a State or political subdivision of a State. An example of "institutional on-farm training" is that authorized by 38 U.S.C. 1652 (formerly section 252 of the Veterans' Readjustment Assistance Act of 1952), as described in section 252 of such act. A full-time student is one who is enrolled for some part of 5 calendar months for the number of hours of courses which is considered to be full-time attendance. The 5 calendar months need not be consecutive. School attendance exclusively at night does not constitute full-time attendance. However, full-time attendance at an educational institution may include some attendance at night in connection with a full-time course of study.

(2) *Educational institution.* For definition of "educational institution," see section 151(e)(4) and § 1.151–3.

§ 1.1304 Statutory provisions; special rules.

Sec. 1304. *Special rules*—(a) *Taxpayer must choose benefits.* This part shall apply to the taxable year only if the taxpayer chooses to have the benefits of this part for such taxable year. Such choice may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for the taxable year.

(b) *Certain provisions inapplicable.* If the taxpayer chooses the benefits of this part for the taxable year, the following provisions shall not apply to him for such year:

(1) Section 3 (relating to optional tax if adjusted gross income is less than $5,000),

(2) Section 72(n)(2) (relating to limitation of tax in case of certain distributions with respect to contributions by self-employed individuals),

(3) Section 911 (relating to earned income from sources without the United States), and

(4) Subpart D of part III of subchapter N (sec. 931 and following, relating to income from sources within possessions of the United States).

(c) *Failure of certain married individuals to make joint return, etc.*—(1) *Application of subsection.* Paragraphs (2), (3), and (4) of this subsection shall apply in the case of any individual who was married for any base period year or the computation year; except that—

(A) Such paragraphs shall not apply in respect of a base period year if—

(i) Such individual and his spouse make a joint return, or such individual makes a return as a surviving spouse (as defined in section 2(b)), for the computation year, and

(ii) Such individual was not married to any other spouse for such base period year, and

(B) Paragraph (4) shall not apply in respect of the computation year if the individual and his spouse make a joint return for such year.

(2) *Minimum base period income.* For purposes of this part, the base period income of an individual for any base period year shall not be less than 50 percent of the base period income which would result from combining his income and deductions for such year—

(A) With the income and deductions for such year of the individual who is his spouse for the computation year, or

(B) If greater, with the income and deductions for such year of the individual who was his spouse for such base period year.

(3) *Minimum base period capital gain net income.* For purposes of this part, the capital gain net income of any individual for any base period year shall not be less than 50 percent of the capital gain net income which would result from combining his capital gain net income for such year (determined without regard to this paragraph) with the capital gain net income for such year (similarly determined) of the individual with whom he is required by paragraph (2) to combine his income and deductions for such year.

(4) *Community income attributable to services.* In the case of amounts which constitute earned income (within the meaning of section 911(b)) and are community income under community property laws applicable to such income—

(A) The amount taken into account for any base period year for purposes of determining base period income shall not be less than the amount which would be taken into account if such amounts did not constitute community income, and

(B) The amount taken into account for purposes of determining adjusted taxable income for the computation year shall not exceed the amount which would be taken into account if such amounts did not constitute community income.

(5) *Marital status.* For purposes of this subsection, section 143 shall apply in determining whether an individual is married for any taxable year.

(d) *Dollar limitations in case of joint returns.* In the case of a joint return, the $3,000 figure contained in section 1301 shall be applied to the aggregate averagable income, and the $3,000 figure contained in section 1302(b)(2)(C) shall be applied to the aggregate net incomes.

(e) *Special rules where there are capital gains*—(1) *Treatment of capital gains in computation year.* In the case of any taxpayer who has capital gain net income for the computation year, the tax imposed by section 1 for the computation year which is attributable to the amount of such net income shall be computed—

(A) By adding so much of the amount thereof as does not exceed average base period capital gain net income above 133⅓ percent of average base period income, and

(B) By adding the remainder (if any) of such net income above the 20 percent of the averagable income as taken into account for purposes of computing the tax imposed by section 1 (and above the amounts (if any) referred to in subsection (f)(1)).

(2) *Computation of alternative tax.* In the case of any taxpayer who has capital gain net income for the computation year, section 1201(b) shall be treated as imposing a tax equal to the tax imposed by section 1, reduced by the amount (if any) by which—

(A) The tax imposed by section 1 and attributable to the capital gain net income for the computation year (determined under paragraph (1)), exceeds

(B) An amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

(f) *Treatment of certain other items*—(1) *Gift or wagering income.* The tax imposed by section 1 for the computation year which is attributable to the amounts subtracted from taxable income under paragraphs (2) and (3) of section 1302(b) shall equal the increase in tax under section 1 which results from adding such amounts above the 20 percent of the averagable income as taken into account for purposes of computing the tax imposed thereon by section 1.

(2) *Section 72(m)(5).* Section 72(m)(5) (relating to penalties applicable to certain amounts received by owner-employees) shall be applied as if this part had not been enacted.

(3) *Other items.* Except as otherwise provided in this part, the order and manner in which items of income shall be taken into account in computing the tax imposed by this chapter on the income of any eligible individual to whom section 1301 applies for any computation year shall be determined under regulations prescribed by the Secretary or his delegate.

(g) *Short taxable years.* In the case of any computation year or base period year which is a short taxable year, this part shall be applied in the manner provided in regulations prescribed by the Secretary or his delegate.

[Sec. 1304 as amended by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

§ 1.1304–1 Choice of income averaging by taxpayer.

(a) *Choice by taxpayer.* The income averaging provisions apply to a taxable year only if the taxpayer chooses to have the benefits of income averaging for such taxable year. The taxpayer shall signify his choice by making his return for the computation year on Form 1040 and attaching Schedule G, Income Averaging, thereto. The taxpayer may make or change his choice of such benefits at any time before the expiration of the period (including extensions thereof) prescribed in section 6511 for making a claim for credit or refund of the tax imposed by chapter 1 of the Code for such taxable year.

(b) *Subsequent qualification.* A taxpayer who was not qualified to choose the benefits of income averaging for a taxable year may subsequently become qualified for such taxable year. For example, if a taxpayer was not qualified to choose the benefits of income averaging

for 1964 incurs a net operating loss in 1965, and the carryback of such loss reduces his income for 1962 and 1963 so that he is no longer ineligible under section 1301 to choose the benefits of income averaging for 1964, the taxpayer may recompute the tax imposed by chapter 1 of the Code on his income for 1964 as if he had originally chosen the benefits of income averaging.

(c) *Subsequent disqualification.* A taxpayer who has chosen the benefits of income averaging for a taxable year may subsequently become disqualified for such benefits for such taxable year. For example, if a taxpayer who chose the benefits of income averaging for 1964 incurs a net operating loss for 1965 and the carryback of such loss reduces his income for 1964 so that he is no longer qualified under section 1301 to choose the benefits of income averaging for that year, the taxpayer must recompute the tax imposed by chapter 1 of the Code on his income for 1964 as if he had not originally chosen the benefits of income averaging.

§ 1.1304–2 Provisions inapplicable if income averaging is chosen.

(a) *Provisions inapplicable.* If a taxpayer chooses the benefits of income averaging for any taxable year, pursuant to section 1304(a) and § 1.1304–1, the following sections of the Code will not apply for such year:

(1) Section 3 (relating to optional tax if adjusted gross income is less than $5,000). A taxpayer may not, therefore, make use of the tax table contained in section 3 for any taxable year for which he chooses the benefits of income averaging. For availability of standard deduction, see section 144(d) and the regulations thereunder.

(2) Section 72(n)(2) (relating to limitation of tax in case of certain distributions with respect to contributions by self-employed individuals).

(3) Section 911 (relating to earned income from sources without the United States). Thus, a taxpayer who chooses the benefits of income averaging for a taxable year may not exclude from his gross income for such year any portion of his earned income from sources without the United States.

(4) Subpart D of Part III of Subchapter N (section 931 and following, relating to income from sources within possessions of the United States). Thus, a taxpayer who chooses the benefits of income averaging for a taxable year may not exclude from his gross income for such year any portion of his income from sources within possessions of the United States. However, the application of this provision for purposes of income averaging shall not affect any subsequent determination under the 3-year rule contained in section 931(a)(1). See § 1.931–1.

(b) *Subsequent disqualification.* The provisions of section 1304(b) and this section do not apply to a taxable year for which a taxpayer chose the benefits of income averaging if he subsequently becomes disqualified for such benefits. See paragraph (c) of § 1.1304–1.

§ 1.1304–3 Special rules for computing base period income.

(a) *Applicability.* Section 1304(c) prescribes the minimum amount of separate base period income of an individual to be taken into account for any base period year in certain circumstances. It applies if an individual was married for any base period year or for the computation year, unless—

(1) For the computation year, such individual and his spouse make a joint return, or he makes a return as a surviving spouse (as defined in section 2(b) and § 1.2–2), and

(2) He was not married to any other spouse for such base period year.

The applicability of this section is determined separately for each base period year. Thus, the provisions of this section may apply to one or more but less than all base period years.

(b) *Minimum separate base period income*—(1) *General rule.* In any case in which section 1304(c) and this section apply, the separate base period income of an individual for a base period year is the greatest of the following amounts:

(i) The individual's separate income and deductions (increased in accordance with subparagraph (A) of section 1304(c)(4), relating to community income) adjusted in accordance with paragraph (c) of § 1.1302–3;

(ii) 50 percent of the base period income resulting from adjusting, in accordance with paragraph (c) of § 1.1302–3, the sum of the individual's separate income and deductions (increased in accordance with subparagraph (A) of section 1304(c)(4), relating to community income) and the separate income and deductions of his spouse for the computation year; or

(iii) 50 percent of the base period income resulting from adjusting, in accordance with paragraph (c) of § 1.1302–3, the sum of the individual's separate income and deductions and the separate income and deductions of his spouse for such base period year.

However, subdivision (ii) of this subparagraph shall not apply in respect of a base period year if an individual and his spouse make a joint return for the computation year.

(2) *Computation of adjustments.* For purposes of subparagraph (1) (ii) and (iii) of this paragraph, in computing the amount of any adjustment under paragraph (c) of § 1.1302–3, an item of income of an individual may not be decreased by a loss incurred by the individual with whom he combines his income, unless such individuals made a joint return for the base period year in question. For example, if an individual has a net long-term capital gain of $20,000 for a base period year and the individual with whom he combines his income has a net long-term capital loss of $5,000 for such year, their combined capital gain net income for such year is $10,000 ($20,000−(50 percent of $20,000)). However, if such individuals made a joint return for such year, their capital gain net income is $7,500 ($15,000−(50 percent of $15,000)).

(c) *Separate income and deductions*—(1) *Definition.* The term "separate income and deductions" for a base period year means the excess an individual's gross income over his allowable separate deductions. The separate income and deductions of an individual may never be less than zero.

(2) *Separate deductions.* (i) An individual's separate deductions for a base period year for which he made a separate return are the deductions allowable on such return.

(ii) An individual's separate deductions for a base period year for which he made a joint return are:

(*a*) In the case of deductions allowable in computing adjusted gross income, the sum of such deductions attributable to the items of his gross income; and

(*b*) In the case of deductions allowable in computing taxable income, an amount which bears the same ratio to the amount of such deductions allowable on the joint return as the amount of adjusted gross income attributable to him for such year bears to the amount of the aggregate adjusted gross income of him and his spouse for such year. However, in any case in which 85 percent or more of the aggregate adjusted gross income of a husband and wife for a taxable year is attributable to either the husband or wife, all of such deductions shall be deemed to be the allowable deductions of the individual to whom 85 percent or more of such income is attributable, and none of such deductions shall be deemed to be the allowable deductions of the other spouse.

(d) *Community income attributable to services.* Under section 1304(c)(4)(A), in any case in which subdivisions (i) and (ii) of subparagraph (1) of paragraph (b) apply, an individual's separate income and deductions (as defined in paragraph (c)), shall be increased to take into account, in the case of amounts which constitute earned income (within the meaning of section 911(b)) and are community income under community property laws applicable to such income, not less than the net amount of such earned income which would be taken into account if such amounts of earned income did not constitute community income.

(e) *Example.* The provisions of this section may be illustrated by the following example:

Example. H and W are calendar year taxpayers who were married, residents of a common law State, and otherwise eligible to choose the benefits of income averaging for the taxable year 1964. They made a joint return for 1964. W, however, was married to and made a joint return with A for the taxable year 1960. H was unmarried for 1960. H, A, and W had taxable income for 1960 as indicated in the table below. H and W compute their base period income for 1960 in the following manner:

	A	W	A and W joint return	H
Salary	$11,500	$3,000	$14,500	$3,000
Dividends	500	1,000	1,500	1,000
Adjusted gross income	12,000	4,000	16,000	4,000
Total deductions allowable in computing taxable income			4,000	1,500
Amount of total deductions allowable in computing separate income and deductions	3,000	1,000		1,500
Separate income and deductions	9,000	3,000	12,000	2,500
Foreign income excluded under section 911	10,000			
Separate base period income in accordance with paragraph (b)(1)(i)	19,000	3,000		2,500

Separate base period income in accordance with paragraph (b):

(1) W's separate income and deductions under subdivision (i) of paragraph (b)(1) $3,000

(2) W's separate base period income under subdivision (iii) of paragraph (b)(1):
(a) W and A's taxable income for 1960 ..... $12,000
(b) Adjustment under paragraph (c) of § 1.1302-3 10,000
22,000
(c) 50 percent of combined base period income 11,000

W must take $11,000 into account as her separate base period income for 1960. Since H made a joint return with W in the computation year and was not married to another spouse in 1960, section 1304(c) and § 1.1304-3 do not apply to him for 1960. Therefore, his separate base period income for 1960 is $2,500. H and W's base period income, on a joint return basis, for 1960 is $13,500.

(f) *Minimum base period capital gain net income.* In any base period year to which section 1304(c) and this section apply, for purposes of determining an individual's average base period capital gain net income under section 1302(d)(2) and paragraph (b) of § 1.1302-4, his capital gain net income for such year shall not be less than 50 percent of the capital gain net income which would result from combining his capital gain net income for such year (determined without regard to section 1304(c)(3) and this paragraph) with the capital gain net income for such year (also determined without regard to section 1304(c)(3) and this paragraph) of the individual with whom he is required, pursuant to paragraph (b) of this section, to combine his separate income and deductions for such year.

(g) *Marital status.* For purposes of section 1304(c) and this section, the rules of section 143 (relating to determination of marital status) and the regulations thereunder apply in determining whether an individual is married for any taxable year.

§ 1.1304-4 Dollar limitations in case of joint returns.

(a) *Averagable income.* Under section 1301 an eligible individual may choose the benefits of income averaging only if his averagable income for the computation year exceeds $3,000. In the case of a joint return, the $3,000 limitation applies to the aggregate averagable income of the husband and wife making the joint return.

(b) *Income attributable to gifts, bequests, etc.* Under section 1302(b)(2)(C) an individual must, in determining his adjusted taxable income for a computation year, decrease his taxable income for such year by the amount of his income attributable to gifts, bequests, devises, and inheritances only if the sum of such amounts exceeds $3,000. Under section 1304(d), the $3,000 limitation with respect to the amount of net income attributable to such interests in property applies, in the case of a joint return, to the aggregate net income of the husband and wife making the joint return.

§ 1.1304-5 Determination of total tax for the computation year.

(a) *Total tax.* The total amount of tax imposed by section 1 for the computation year on the income of an individual for that year is the sum of the separate amounts of tax imposed on the several segments of the income of the individual who chooses the benefits of income averaging for such year. The several segments of an individual's income arranged in ascending order (from the standpoint of the tax rate brackets applicable to such segments of income) are:

Segment 1. The amount of income equal to 133⅓ percent of average base period income.

Segment 2. The amount (if any) of the adjustment for capital gains made to averagable income under section 1302(a)(2).

Segment 3. The amount (if any) of capital gain net income for the computation year which is less than or equal to average base period capital gain net income.

Segment 4. Twenty percent of averagable income.

Segment 5. The amount (if any) of items of income not specifically included in any other segment.

Segment 6. The amount (if any) of capital gain net income for the computation year which exceeds average base period capital gain net income.

Segment 7. The amount (if any) of income to which section 72(m)(5), relating to certain distributions to owner-employees which are subject to penalties, applies.

(b) *Treatment of segment 5 items.* The tax imposed by section 1 for the computation year on items of income in segment 5 shall equal the increase in tax resulting from adding such amounts to an individual's income immediately above 20 percent of averagable income (segment 4) as such averagable income is taken into account for purposes of computing the tax imposed on such averagable income by section 1. Segment 5 includes the items of income by which taxable income is decreased in determining adjusted taxable income under section 1302(b)(2) and paragraph (c) of § 1.1302-2, section 1302(b)(3) and paragraph (d) of § 1.1302-2, paragraph (f) of § 1.1302-2, and paragraph (g) of § 1.1302-2.

(c) *Treatment of certain amounts received by owner-employees.* The amount of tax imposed by section 1 for the computation year attributable to amounts described in section 72(m)(5)(A), to which a penalty is applicable under section 72(m)(5) and paragraph (e) of § 1.72-17, is computed by determining the increase in tax which results under section 1 from the inclusion of such amounts in income without the use of the income averaging provisions.

(d) *Examples.* The application of the rules described in this section may be illustrated by the following examples:

Example (1). A, an eligible individual who was not married for the taxable years 1960 through 1964, has taxable income for those years as indicated in the table below. For the taxable years 1960 through 1963, all of A's income is ordinary income from salary. For the taxable year 1964, all of A's income is ordinary income, and includes $5,000 of net income attributable to property received by bequest in 1964. A's qualification to choose the benefits of income averaging and the amount of his averagable income for 1964 are determined in the following manner:

Year:	*Taxable income*
1960	$2,000
1961	4,000
1962	3,500
1963	2,500
1964	49,000

(1) Adjusted taxable income for 1964 (computation year):
(a) Taxable income for 1964 ..... $49,000
Less:
(b) Income attributable to bequest 5,000
Adjusted taxable income 44,000

(2) Average base period income for years 1960-63 (the base period years):
(a) 1960 2,000
1961 4,000
1962 3,500
1963 2,500
12,000

(b) Average base period income ($12,000÷4) 3,000

(3) Averagable income for 1964:
(a) Adjusted taxable income 44,000
Less:
(b) 133⅓ percent of average base period income (⅓×$3,000) 4,000
Averagable income 40,000

Since A's averagable income exceeds $3,000, the entire amount ($40,000) of his averagable income is subject to averaging.

Computation of tax due for computation year (1964):

(1) Segments of income:
(a) 133⅓ percent of the average base period income $4,000
(b) 20 percent of the averagable income ($40,000÷5) 8,000
(c) Income attributable to bequest 5,000
17,000

(2) Tax attributable to the averagable income:
- (a) Tax on $4,000 — 740
- (b) Tax on $12,000 ($4,000+$8,000) — 3,040
- (c) Tax on 20 percent of averagable income ($3,040—$740) — 2,300
- (d) Multiply tax by 5 (5× $2,300) — 11,500

(3) Tax attributable to the income attributable to bequest:
- (a) Tax on $17,000 — 5,055
- (b) Tax on $12,000 — 3,040
- — 2,015

(4) Total tax for 1964:
- (a) Tax on 133⅓ percent of the average base period income ($4,000) — 740
- (b) Tax on averagable income ($40,000) — 11,500
- (c) Tax on income attributable to bequest ($5,000) — 2,015
- Total tax — 14,255

Example (2). A, an eligible individual who was not married for the taxable years 1960 through 1964, has taxable income for those years as indicated in the table below. For the taxable years 1960 through 1963, all of his ordinary income is from salary and all of his capital gain is net long-term capital gain. For the taxable year 1964, A's ordinary income includes $5,000 of net income attributable to a bequest received by A in 1964. A's qualification to choose the benefits of income averaging and the amount of his averagable income for 1964 are determined in the following manner:

Year	Taxable income		
	Total	Ordinary income	Capital gain net income
1960	$8,250	$2,000	$6,250
1961	7,750	4,000	3,750
1962	7,500	3,500	4,000
1963	8,500	2,500	6,000
1964	59,000	49,000	10,000

(1) Adjusted taxable income for 1964 (the computation year):
- (a) Taxable income for 1964 — $59,000
- Less:
- (b) (i) Capital gain net income for the computation year — $10,000
- (ii) Income attributable to bequest — 5,000
- Total — 15,000
- Adjusted taxable income — 44,000

(2) Average base period income for years 1960–63 (the base period years):
- (a) 1960 — $2,000
- 1961 — 4,000
- 1962 — 3,500
- 1963 — 2,500
- — 12,000
- (b) $12,000÷4 — 3,000

(3) Average base period capital gain net income:
- (a) 1960 — 6,250
- 1961 — 3,750
- 1962 — 4,000
- 1963 — 6,000
- — 20,000
- (b) $20,000÷4 — 5,000

(4) Averagable income for 1964:
- (a) Adjusted taxable income — 44,000
- Less:
- (b) 133⅓ percent of average base period income (4/3× $3,000) — 4,000
- Averagable income — 40,000

Since A's averagable income exceeds $3,000, the entire amount ($40,000) of his averagable income is subject to averaging.

Computation of tax due for computation year (1964):

(1) Segments of income:
- (a) 133⅓ percent of the average base period income — $4,000
- (b) The average base period capital gain net income — 5,000
- (c) 20 percent of the averagable income ($40,000÷5) — 8,000
- (d) Income attributable to bequest — 5,000
- (e) Excess of computation year capital gain net income over average base period capital gain net income $10,000—$5,000) — 5,000
- — 27,000

(2) Tax attributable to the averagable income:
- (a) Tax on $9,000 — 2,055
- (b) Tax on $17,000 — 5,055
- (c) Tax on 20 percent of averagable income ($5,055—$2,055) — 3,000
- (d) Multiply tax by 5 (5× $3,000) — 15,000

(3) Tax attributable to the income attributable to bequest:
- (a) Tax on $22,000 — 7,460
- Less:
- (b) Tax on $17,000 — 5,055
- — 2,405

(4) Tax attributable to the excess of computation year capital gain net income over average base period capital gain net income:
- (a) Tax on $27,000 — 10,160
- Less:
- (b) Tax on $22,000 — 7,460
- — 2,700

(5) Total tax for 1964:
- (a) Tax on 133⅓ percent of the average base period income ($4,000) — 740
- (b) Tax on average base period capital gain net income ($5,000) — 1,315
- (c) Tax on averagable income ($40,000) — $15,000
- (d) Tax on income attributable to bequest ($5,000) — 2,405
- (e) Tax on excess capital gain net income ($5,000) — 2,700
- Total tax — 22,160

Example (3). The facts are the same as in example (2) for the taxable years 1960 to 1963. For the taxable year 1964, A's taxable income is $47,000, of which $44,000 is ordinary income and the remaining $3,000 is attributable to his $6,000 of net long-term capital gain.

(1) Adjusted taxable income for 1964 (the computation year):
- (a) Taxable income for 1964 — $47,000
- Less:
- (b) Capital gain net income for the computation year — 3,000
- Adjusted taxable income — 44,000

(2) Average base period income for years 1960–63 (the base period years) — 3,000

(3) Average base period capital gain net income — 5,000

(4) Averagable income for 1964:
- (a) Adjusted taxable income — 44,000
- Less:
- (b) 133⅓ percent of average base period income (⅓× $3,000) — 4,000
- Total — 40,000
- Less:
- (c) The adjustment for capital gains:
  - (i) Average base period capital gain net income — $5,000
  - Less:
  - (ii) Capital gain net income for the computation year — 3,000
- Total — 2,000
- Averagable income — 38,000

Since A's averagable income exceeds $3,000, the entire amount ($38,000) of his averagable income is subject to averaging.

Computation of tax due for computation year (1964):

(1) Segments of income:
- (a) 133⅓ percent of the average base period income (⅓× $3,000) — $4,000
- (b) Adjustment for capital gains — 2,000
- (c) The amount of the computation year capital gain net income — 3,000
- (d) 20 percent of the averagable income ($38,000÷5) — 7,600
- Total — 16,600

(2) Tax attributable to the averagable income:
- (a) Tax on $9,000 — $2,055
- (b) Tax on $16,600 — 4,877
- (c) Tax on 20 percent of averagable income ($4,877—$2,055) — 2,822
- (d) Multiply tax by 5 (5× $2,822) — 14,110

(3) Total tax for 1964:	
(a) Tax on 133⅓ percent of the average base period income ($4,000)	$740
(b) Tax on the adjustment for capital gains ($2,000)	470
(c) Tax on computation year capital gain net income ($3,000)	845
(d) Tax on averagable income ($38,000)	14,110
Total tax	16,165

§ 1.1304–6 Special rule for computation of alternative tax.

(a) If an individual has capital gain net income, section 1201(b) is treated as imposing an alternative tax in lieu of the tax imposed by section 1, if such alternative tax is less than the tax imposed by section 1. The alternative tax is equal to the tax imposed by section 1, reduced by the amount by which—

(1) The tax imposed by section 1 which is attributable to an individual's capital gain net income for the computation year (as determined under section 1304(e)(1) and § 1.1304–5), exceeds

(2) An amount equal to 25 percent of the excess of such individual's net long-term capital gain for the computation year over his net short-term capital loss for such year.

See § 1.1–3 for rule relating to the computation of the limitation on tax under section 1(c) in cases where the alternative tax is imposed. For purposes of paragraph (a) of § 1.34–2 relating to the limitation on amount of the dividend received credit under section 34) and paragraph (a) of § 1.35–1 (relating to computation of credit for partially tax-exempt interest under section 35) in any case where the alternative tax is imposed, taxable income for a taxable year is an individual's taxable income as defined in section 63.

(b) The application of the rules described in this paragraph may be illustrated by the following example:

Example. A, an eligible individual who was not married for the taxable years 1960 through 1964, has taxable income for those years as indicated in the table below. For the taxable years 1960 through 1964, all of his ordinary income is from salary and all of his capital gain is net long-term capital gain. A's qualification to choose the benefits of income averaging and the amount of his averagable income for 1964 are determined in the following manner:

Year	Taxable income		
	Total	Ordinary income	Capital gain net income
1960	$8,250	$2,000	$6,250
1961	7,750	4,000	3,750
1962	7,500	3,500	4,000
1963	8,500	2,500	6,000
1964	84,000	44,000	40,000

(1) Adjusted taxable income for 1964 (the computation year):	
(a) Taxable income for 1964	$84,000
Less:	
(b) Capital gain net income for the computation year	40,000
Adjusted taxable income	44,000
(2) Average base period income for years 1960–63 (the base period years) (See example 2, § 1.1304–5(d))	$3,000
(3) Average base period capital gain net income (See example 2, § 1.1304–5(d))	5,000
(4) Averagable income for 1964:	
(a) Adjusted taxable income	44,000
Less:	
(b) 133⅓ percent of average base period income (⅓ × $3,000)	4,000
Averagable income	40,000

Since A's averagable income exceeds $3,000, the entire amount ($40,000) of his averagable income is subject to averaging.

Computation of the tax due for computation year (1964):

(1) Segments of income:	
(a) 133⅓ percent of the average base period income	$4,000
(b) The average base period capital gain net income	5,000
(c) 20 percent of the averagable income ($40,000 ÷ 5)	8,000
(d) Excess of computation year capital gain net income over average base period capital gain net income	35,000
Total	52,000
(2) Tax attributable to the averagable income:	
(a) Tax on $9,000	2,055
(b) Tax on $17,000	5,055
(c) Tax on 20 percent of averagable income ($5,055—$2,055)	3,000
(d) Multiply tax by 5 (5 × $3,000)	15,000
(3) Tax attributable to the excess of computation year capital gain net income over average base period capital gain net income:	
(a) Tax on $52,000	25,260
Less:	
(b) Tax on $17,000	5,055
	20,205
(4) Total tax for 1964:	
(a) Tax on 133⅓ percent of the average base period income ($4,000)	740
(b) Tax on average base period capital gain net income ($5,000)	1,315
(c) Tax on averagable income ($40,000)	15,000
(d) Tax on excess capital gain net income ($35,000)	20,205
Total tax	37,260

Computation of alternative tax for computation year (1964):

(1) Tax equal to the tax imposed by sec. 1 of the Code	$37,260
(2) Amount (if any) of reduction in tax:	
(a) Tax imposed by sec. 1 of the Code which is attributable to the amount of capital gain net income for the computation year which is equal to the average base period capital gain net income ($5,000)	1,315
(b) Tax imposed by sec. 1 of the Code which is attributable to the excess of capital gain net income for the computation year over the average base period capital gain net income ($35,000)	$20,205
Total tax attributable to capital gain net income for the computation year	21,520
(c) Amount which is 25 percent of net long-term capital gain for computation year ($80,000)	20,000
Reduction in tax	1,520
(3) Alternative tax for 1964 ($37,260—$1,520)	35,740

§ 1.1304–7 Short taxable years.

(a) *Change of annual accounting period.* (1) If an individual is required under section 443(a)(1) and the regulations thereunder to make a return for a short period, such short period may be treated as a computation year or a base period year. For purposes of this section, a "short period" means any period of less than 12 months for which a return was required to be made under section 443(a).

(2) For a short period which is a computation year, an individual shall determine his eligibility to choose the benefits of income averaging by placing his taxable income on an annual basis by multiplying such income by 12 and dividing the result by the number of months in the short period. The provisions of section 443(c) and the regulations thereunder (relating to adjustment in deduction for personal exemptions) shall apply in such computations. The total tax imposed by section 1 for the short period which is a computation year shall be the same part of the total tax computed on the annual basis as the number of months in the short period is of 12 months. The period described in section 443(b)(2) (relating to computation based on 12-month period) may not be a computation year.

(3) For a short period which is a base period year, the amount of an individual's base period income for such short period is computed as if such short period were a taxable year of 12 months ending on the last day of the short period.

(4) The application of the rules described in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. A, an unmarried, eligible individual who had been a calendar year taxpayer, was allowed in 1964 to change his annual accounting period to a taxable year beginning on April 1. A made a return for

the short period from January 1 to March 31, 1964. His taxable income for the taxable years 1960 to 1964 is as indicated in the table below. For the taxable years 1960 through 1963, all of A's income is ordinary income from salary. For the short period, all of A's income is ordinary income, and includes $5,000 of net income attributable to a bequest received in 1964. A's eligibility to choose the benefits of income averaging and the amount of his averagable income for 1964 are determined in the following manner:

Year:	*Taxable income*
1960	$12,000
1961	14,000
1962	17,500
1963	16,500
1964 (3 months)	15,000

(1) Adjusted taxable income for 1964 (computation year):	
(a) Taxable income for 1964 on annual basis (($15,000×12)÷3)	60,000
Less:	
(b) Income attributable to bequest on annual basis (($5,000×12)÷3)	20,000
Adjusted taxable income	40,000
(2) Average base period income for years (1960–1963) (the base period years):	
(a) 1960	12,000
1961	14,000
1962	17,500
1963	16,500
	60,000
(b) Average base period income ($60,000÷4)	15,000
(3) Averagable income for 1964:	
(a) Adjusted taxable income	40,000
Less:	
(b) 133⅓ percent of average base period income (4/3×$15,000)	20,000
Averagable income	20,000

Since A's averagable income exceeds $3,000, the entire amount ($20,000) of his averagable income is subject to averaging.

Computation of total tax due for computation year (1964):

(1) Segments of income on annual basis:	
(a) 133⅓ percent of the average base period income	$20,000
(b) 20 percent of the averagable income ($20,000÷5)	4,000
(c) Income attributable to bequest	20,000
	44,000
(2) Tax attributable to the averagable income:	
(a) Tax on $20,000	6,450
(b) Tax on $24,000	8,530
(c) Tax on 20 percent of averagable income ($8,530—$6,450)	2,080
(d) Multiply tax by 5 (5×$2,080)	10,400
(3) Tax attributable to the income attributable to bequest:	
Tax on $44,000	20,130
Less: Tax on $24,000	8,530
	11,600
(4) Total tax for 1964:	
(a) Tax on 133⅓ percent of average base period income ($20,000)	6,450
(b) Tax on averagable income on annual basis ($20,000)	10,400
(c) Tax on income attributable to bequest on annual basis ($20,000)	11,600
(d) Tax on annualized income ($60,000)	28,450
Total tax due ($28,450×3/12)	7,112.50

(b) *Taxpayer not in existence for entire taxable year.* If an individual is required under section 443(a)(2) and the regulations thereunder to make a return for a short period, such short period may be treated as a computation year or a base period year. The amount of such individual's adjusted taxable income (if such short period is a computation year) or his base period income (if such short period is a base period year) is computed as if such short period were a taxable year of 12 months ending on the last day of the short period.

(c) *Termination of taxable year for jeopardy.* An individual who is required under section 443(a)(3) and the regulations thereunder to make a return for a period of less than 12 months shall not take such short period into account as a computation year or a base period year.

§ 1.1305 Statutory provisions; regulations.

Sec. 1305. *Regulations.* The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this part.

[Sec. 1305 as amended by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

PAR. 2. Section 1.72 is amended by striking out paragraph (3) of section 72 (e) and by revising the historical note. The amended provisions read as follows:

§ 1.72 Statutory provisions; annuities; certain proceeds of endowment and life insurance contracts.

Sec. 72. *Annuities; certain proceeds of endowment and life insurance contracts.* * * *

(e) *Amounts not received as annuities.* * * *

(3) [Deleted]

[Sec. 72 as amended by sec. 4 (a), (b), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 821); sec. 11(b), Rev. Act 1962 (76 Stat. 1005); sec. 232(b), Rev. Act 1964 (78 Stat. 110)]

PAR. 3. Paragraph (a)(3)(i) of § 1.72–2 is amended to read as follows:

§ 1.72–2 Applicability of section.

(a) *Contracts.* * * *

(3)(i) Sections 402 and 403 provide that certain distributions by employees' trusts and certain payments under employee plans are taxable under section 72. For taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, does not apply to such distributions or payments. For purposes of applying section 72 to such distributions and payments (other than those described in subdivision (iii) of this subparagraph), each separate program of the employer consisting of interrelated contributions and benefits shall be considered a single contract. Therefore, all distributions or payments (other than those described in subdivision (iii) of this subparagraph) which are attributable to a separate program of interrelated contributions and benefits are considered as received under a single contract. A separate program of interrelated contributions and benefits may be financed by the purchase from an insurance company of one or more group contracts or one or more individual contracts, or may be financed partly by the purchase of contracts from an insurance company and partly through an investment fund, or may be financed completely through an investment fund. A program may be considered separate for purposes of section 72 although it is only a part of a plan which qualifies under section 401. There may be several trusts under one separate program, or several separate programs may make use of a single trust. See, however, subdivision (iii) of this subparagraph for rules relating to what constitutes a "contract" for purposes of applying section 72 to distributions commencing before October 20, 1960.

* * * * *

PAR. 4. Section 1.72–11 is amended by revising paragraphs (a)(2), (c)(3), (d)(2), (f)(1), (3), and (g). These amended provisions read as follows:

§ 1.72–11 Amounts not received as annuity payments.

(a) *Introductory.* * * *

(2) The principles of this section apply, to the extent appropriate thereto, to amounts paid which are taxable under section 72 (except, for taxable years beginning before January 1, 1964, section 72(e)(3)) in accordance with sections 402 and 403 and the regulations thereunder. However, if contributions used to purchase the contract include amounts for which a deduction was allowed under section 404 as contributions on behalf of an owner-employee, the rules of this section are modified by the rules of paragraph (b) of § 1.72–17. Further, in applying the provisions of this section, the aggregate premiums or other consideration paid shall not include contributions on behalf of self-employed individuals to the extent that deductions were allowed under section 404 for such contributions. Nor, shall the aggregate of premiums or other consideration paid include amounts used to purchase life, accident, health, or other insurance protection for an owner-employee. See paragraph (b)(4) of § 1.72–16 and paragraph (c) of § 1.72–17. The principles of this section also apply to payments made in the manner described in paragraph (b)(3)(i) of § 1.72–2.

* * * * *

(c) *Amounts received in the nature of a refund of the consideration under a contract and in full discharge of the obligation thereof.* * * *

(3) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received in full discharge of the obligation is the

same person as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72–10. For the limit on the tax, for taxable years beginning before January 1, 1964, attributable to the receipt of a lump sum to which this paragraph applies, see paragraph (g) of this section.

(d) *Amounts received upon the surrender, redemption, or maturity of a contract.* * * *

(2) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received upon the surrender, redemption, or maturity of the contract is the same as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72–10. For the limit on the amount of tax, for taxable years beginning before January 1, 1964, attributable to the receipt of certain lump sums to which this paragraph applies, see paragraph (g) of this section.

* * * * *

(f) *Periodic payments received for the same term after a lump sum withdrawal.* (1) If, after the date of the first receipt of a payment as an annuity, the annuitant receives a lump sum and is thereafter to receive annuity payments in a reduced amount under the contract for the same term, life, or lives as originally specified in the contract, a portion of the contract shall be considered to have been surrendered or redeemed in consideration of the payment of such lump sum and the exclusion ratio originally determined for the contract shall continue to apply to the amounts received as an annuity without regard to the fact that such amounts are less than the original amounts which were to be paid periodically. The lump sum shall be includible in the gross income of the recipient in accordance with the provisions of subparagraph (2) of this paragraph. However, except in the case of amounts to which sections 402 and 403 apply, the tax, for taxable years beginning before January 1, 1964, attributable to the inclusion of all or part of the lump sum in gross income shall not exceed the amount determined under section 72(e)(3) and paragraph (g) of this section. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

* * * * *

(3) This paragraph may be illustrated by the following examples:

Example (1). Taxpayer A pays $20,000 for an annuity contract providing for payments to him of $100 per month for his life. At the annuity starting date he has a life expectancy of 20 years. His expected return is therefore $24,000 and the exclusion ratio is five-sixths. He continues to receive the original annuity payments for 5 years, receiving a total of $6,000, and properly excludes a total of $5,000 from his gross income in his income tax returns for those years. At the beginning of the next year, A agrees with the insurer to take a reduced annuity of $75 per month and a lump sum payment of $4,000 in cash. Of the lump sum he receives, he will include $250 and exclude $3,750 from his gross income for his taxable year of receipt, determined as follows:

Aggregate of premiums or other consideration paid	$20,000
Less amounts received as an annuity to the extent they were excludable from A's income	$5,000
Remainder of the consideration	$15,000
Ratio of the reduction in the amount of the annuity payments to the original annuity payments	25/$100 or ¼
Lump sum received	$4,000
Less one-fourth of the remainder of the consideration (¼ of $15,000)	$3,750
Portion of the lump sum includible in gross income	$250

For taxable years beginning before January 1, 1964, the limit on tax of section 72(e)(3), as in effect before such date, applies to the portion of the lump sum includible in gross income. For taxable years beginning after December 31, 1963, such portion may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). If, in this example, the annuity were a pension payable to A as a retired employee, but the facts were otherwise the same (assuming that, for instance, the $20,000 aggregate of premiums or other consideration paid were A's contributions as determined under section 72(f) and § 1.72–8) the result would be the same except that the tax attributable to the inclusion of the $250 in A's gross income, for taxable years beginning before January 1, 1964, would not be limited by section 72(e)(3), as in effect before such date. If such a lump sum is received in a taxable year beginning after December 31, 1963, the portion of such sum includible in gross income may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

Example (2). Taxpayer B pays $30,000 for a contract providing for monthly payments to be made to him for 15 years with respect to the principal and earnings of 10 units of an investment fund. B receives $12,000 during the first 5 years of participation and of this amount he has properly excluded a total of $10,000 from his gross income in his income returns for the taxable years, since $2,000 of $2,400 he received in each such year represented his investment divided by the term of the annuity ($30,000÷15). At the beginning of the 6th year, B agrees to take $11,000 in a lump sum and thereafter to accept the payments arising with respect to five units for the remaining 10 years of payments in full discharge of the original obligations of the contract. B shall include $1,000 in his gross income for the 6th year as the result of the lump sum he receives and allocates $1,000 of his original investment in the contract to each of the remaining 10 years with respect to the payments which will continue, determined as follows:

Aggregate of premiums or other consideration paid	$30,000
Total amount received and excludable from gross income	$10,000
Remainder of the consideration	$20,000
Ratio of units discontinued to the total units originally provided	5/10 or ½
Lump sum received at the time of reduction in the number of units to be paid	$11,000
Less one-half of the remainder of the consideration (½ of $20,000)	$10,000
Portion of the lump sum received and includible in gross income	$1,000
Remainder of the consideration less the portion of such remainder attributable to the excludable portion of the lump sum ($20,000—$10,000)	$10,000
Remainder of the consideration properly allocable to each taxable year for the remaining 10 years ($10,000÷10)	$1,000

For the taxable years beginning before January 1, 1964, the limit on tax of section 72(e)(3), as in effect before such date, applies to the portion of the lump sum received and includible in gross income. For taxable years beginning after December 31, 1963, such portion may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(g) *Limit on tax attributable to the receipt of a lump sum.* (1) For taxable years beginning before January 1, 1964, if the entire amount of the proceeds received upon the redemption, maturity, surrender, or discharge of a contract to which section 72 applies is received in a lump sum and paragraph (c), (d), or (f) of this section is applicable in determining the portion of such amount which is includible in gross income, the tax attributable to such portion shall not exceed the tax which would have been attributable thereto had such portion been received ratably in the taxable year in which received and the 2 preceding taxable years. The amount of tax attributable to the includible portion of the lump sum received shall be the lesser of:

(i) The difference between the amount of tax for the taxable year of receipt computed by including such portion in gross income and the amount of tax for such taxable year computed by excluding such portion from gross income; or

(ii) The difference between the total amount of tax for the taxable year of receipt and the 2 preceding taxable years computed by including one-third of such portion in gross income for each of the 3 taxable years, and the total amount of the tax for the taxable year of receipt and the 2 preceding taxable years computed by entirely excluding such portion from the gross income of all 3 taxable years.

For the definition of "taxable year", see section 441(b). This subparagraph shall not apply, for taxable years beginning before January 1, 1964, to payments excepted from the application of section 72(e)(3), as in effect before such date, under the provisions of section 402 or 403. See paragraph (a) of § 1.72–2 and paragraph (d) of § 1.72–14.

(2) For taxable years beginning after December 31, 1963, any amount includible in gross income to which this section relates may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

PAR. 5. Paragraph (b)(3) of § 1.72–17 is amended to read as follows:

§ 1.72–17 Special rules applicable to owner-employees.

* * * * *

(b) *Certain amounts received before annuity starting date.* * * *

(3) Any amounts to which this paragraph applies and which are not includible in gross income under the rules of subparagraph (2) of this paragraph shall be subject to the provisions of section 72(e) and § 1.72–11. However, for taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts (other than amounts subject to a penalty under section 72(m)(5) and paragraph (e) of this section) may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

* * * * *

PAR. 6. Paragraph (b)(3)(iii) of § 1.72–18 is amended to read as follows:

§ 1.72–18 Treatment of certain total distributions with respect to self-employed individuals.

* * * * *

(b) *Distribution to which this section applies.* * * *

(3) * * *

(iii) Distributions or payments made to the employee from a plan or trust unless contributions which were allowed as a deduction under section 404 have been made on behalf of such employee as a self-employed individual under such trust or plan for 5 or more taxable years (whether or not consecutive) prior to the taxable year in which such distributions or payments are made. Distributions or payments to which this section does not apply by reason of this subdivision are taxed as otherwise provided in section 72. However, for taxable years beginning before January 1, 1964, section 72(e)(3), as in effect before such date, is not applicable. For taxable years beginning after December 31, 1963, such distributions or payments may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

* * * * *

PAR. 7. Section 1.144 is amended by adding a new subsection (d) to section 144 and by revising the historical note. These added and amended provisions read as follows:

§ 1.144 Statutory provisions; election of standard deduction.

Sec. 144. *Election of standard deduction.* * * *

(d) *Individuals electing income averaging.* In the case of a taxpayer who chooses to have the benefits of part I of subchapter Q (relating to income averaging) for the taxable year—

(1) Subsection (a) shall not apply for such taxable year, and

(2) The standard deduction shall be allowed if the taxpayer so elects in his return for such taxable year.

The Secretary or his delegate shall by regulations prescribe the manner of signifying such election in the return. If the taxpayer on making his return fails to signify, in the manner so prescribed, his election to take the standard deduction, such failure shall be considered his election not to take the standard deduction.

* * * * *

[Sec. 144 as amended by secs. 112(c), 232(c), Rev. Act 1964 (78 Stat. 24, 110)]

PAR. 8. The following new section is added after § 1.144–2:

§ 1.144–3 Standard deduction for individuals choosing income averaging.

(a) In the case of an individual who chooses under section 1304(a) to have the benefits of part I of subchapter Q (relating to income averaging) for the taxable year—

(1) Section 144(a) shall not apply, and

(2) The standard deduction under section 141 shall be allowed if an individual so elects in his return for such computation year.

Thus, even though an individual who chooses the benefits of income averaging for a taxable year may not pay the tax imposed under section 3, such individual may elect the standard deduction under section 141.

(b) The standard deduction shall be allowed to an individual if he elects on his return for the computation year to take such deduction. Such individual shall signify on his return his election to take the standard deduction by claiming thereon the deduction in the amount provided for in section 141 instead of itemizing the deductions (other than those specified in sections 62 and 151) allowable in computing taxable income. In the case of a husband and wife (whether separate or joint returns are filed), the election to take the standard deduction and the manner of signifying such election shall, to the extent not limited by section 142 and the regulations thereunder, be made in accordance with these rules.

(c) A change of the election to take, or not to take, the standard deduction for any computation year shall be made in accordance with the rules provided in § 1.144–2.

PAR. 9. Section 1.402(a) is amended by revising section 402(a)(1) and by adding a historical note. These amended and added provisions read as follows:

§ 1.402(a) Statutory provisions; taxability of beneficiary of employees' trust; exempt trust.

Sec. 402. *Taxability of beneficiary of employees' trust*—(a) *Taxability of beneficiary of exempt trust*—(1) *General rule.* Except as provided in paragraphs (2) and (4), the amount actually distributed or made available to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities). The amount actually distributed or made available to any distributee shall not include net unrealized appreciation in securities of the employer corporation attributable to the amount contributed by the employee. Such net unrealized appreciation and the resulting adjustments to basis of such securities shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

* * * * *

[Sec. 402(a) as amended by sec. 4(c), Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 825); sec. 232(e)(1), Rev. Act 1964 (78 Stat. 111)]

PAR. 10. Paragraph (a)(1)(ii) of § 1.402(a)–1 is amended to read as follows:

§ 1.402(a)–1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) *In general.* (1) * * *

(ii) The provisions of section 402(a) relate only to a distribution by a trust described in section 401(a) which is exempt under section 501(a) for the taxable year of the trust in which the distribution is made. With two exceptions, the distribution from such an exempt trust when received or made available is taxable to the distributee to the extent provided in section 72 (relating to annuities). First, for taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such distributions. For taxable years beginning after December 31, 1963, such distributions may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). Secondly, certain total distributions described in section 402(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see subparagraph (6) of this paragraph. Under certain circumstances, an amount representing the unrealized appreciation in the value of the securities of the employer is excludable from gross income for the year of distribution. For the rules relating to such exclusion, see paragraph (b) of this section. Furthermore, the exclusion provided by section 105(d) is applicable to a distribution from a trust described in section 401(a) and exempt under section 501(a) if such distribution constitutes wages or payments in lieu of wages for a period during which an employee is absent from work on account of a personal injury or sickness. See § 1.72–15 for the rules relating to the tax treatment of accident or health benefits received under a plan to which section 72 applies.

* * * * *

PAR. 11. Section 1.402(b) is amended by revising section 402(b) and by adding a historical note. These amended and added provisions read as follows:

§ 1.402(b) Statutory provisions; taxability of beneficiary of employees' trust; nonexempt trust.

Sec. 402. *Taxability of beneficiary of employees' trust.* * * *

(b) *Taxability of beneficiary of nonexempt trust.* Contributions to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under section 501(a) shall be included in the gross income of an employee for the taxable year in which the contribution is made to the trust in the

case of an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made. The amount actually distributed or made available to any distributee by any such trust shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities).

* * * * *

[Sec. 402(b) as amended by sec. 232(e)(2), Rev. Act 1964 (78 Stat. 111)]

PAR. 12. Paragraph (b) of § 1.402(b)–1 is amended to read as follows:

§ 1.402(b)–1 Treatment of beneficiary of a trust not exempt under section 501(a).

* * * * *

(b) *Taxation of distributions from trust not exempt under section 501(a).* Any amount actually distributed or made available to any distributee by an employees' trust which is not exempt under section 501(a) for the taxable year of the trust in which the distribution is made shall be taxable in the year in which so distributed or made available under section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). If, for example, the distribution from such a trust consists of an annuity contract, the amount of the distribution shall be considered to be the entire value of the contract at the time of distribution, and such value is includible in the gross income of the distributee at the time of the distribution to the extent that such value exceeds the investment in the contract determined by applying sections 72 and 101(b). The distributions by such an employees' trust shall be taxed as provided in section 72, whether or not the employee's rights to the contributions were nonforfeitable when the contributions were made or at any time thereafter. For rules relating to the treatment of employer contributions to a non-exempt trust as part of the consideration paid by the employee, see section 72(f). For rules relating to the treatment of the limited exclusion allowable under section 101(b)(2)(D) as additional consideration paid by the employee, see the regulations under that section.

PAR. 13. Section 1.402(d) is amended by revising the language following section 402(d)(3) and by adding a historical note. These amended and added provisions read as follows:

§ 1.402(d) Statutory provisions; taxability of beneficiary of employees' trust; annuities under agreements entered into prior to October 21, 1942.

Sec. 402. *Taxability of beneficiary of employees' trust.* * * *

(d) *Certain employees' annuities.* Notwithstanding subsection (b) or any other provision of this subtitle, a contribution to a trust by an employer shall not be included in the gross income of the employee in the year in which the contribution is made if—

(1) Such contribution is to be applied by the trustee for the purchase of annuity contracts for the benefit of such employee;

(2) Such contribution is made to the trustee pursuant to a written agreement entered into prior to October 21, 1942, between the employer and the trustee, or between the employer and the employee; and

(3) Under the terms of the trust agreement the employee is not entitled during his lifetime, except with the consent of the trustee, to any payments under annuity contracts purchased by the trustee other than annuity payments.

The employee shall include in his gross income the amounts received under such contracts for the year received as provided in section 72 (relating to annuities). This subsection shall have no application with respect to amounts contributed to a trust after June 1, 1949, if the trust on such date was exempt under section 165(a) of the Internal Revenue Code of 1939. For purposes of this subsection, amounts paid by an employer for the purchase of annuity contracts which are transferred to the trustee shall be deemed to be contributions made to a trust or trustee and contributions applied by the trustee for the purchase of annuity contracts; the term "annuity contracts purchased by the trustee" shall include annuity contracts so purchased by the employer and transferred to the trustee; and the term "employee" shall include only a person who was in the employ of the employer, and was covered by the agreement referred to in paragraph (2), prior to October 21, 1942.

* * * * *

[Sec. 402(d) as amended by sec. 232(e)(3), Rev. Act. 1964 (78 Stat. 111)]

PAR. 14. Paragraph (a) of § 1.402(d)–1 is amended to read as follows:

§ 1.402(d)–1 Effect of section 402(d).

(a) If the requirements of section 402(d) are met, a contribution made by an employer on behalf of an employee to a trust which is not exempt under section 501(a) shall not be included in the income of the employee in the year in which the contribution is made. Such contribution will be taxable to the employee, when received in later years, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such contributions. For taxable years beginning after December 31, 1963, such contributions, when received, may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). See paragraph (b) of § 1.403(c)–1. The intent and purpose of section 402(d) is to give those employees, covered under certain non-exempt trusts to which such section applies, essentially the same tax treatment as those covered by trusts described in section 401(a) and exempt under section 501(a), except that the capital gains treatment referred to in section 402(a)(2) does not apply.

* * * * *

PAR. 15. Section 1.403(a) is amended by revising section 403(a)(1) and by revising the historical note. These amended provisions read as follows:

§ 1.403(a) Statutory provisions; taxation of employee annuities; qualified annuity plan.

Sec. 403. *Taxation of employee annuities*—(a) *Taxability of beneficiary under a qualified annuity plan*—(1) *General rule.* Except as provided in paragraph (2), if an annuity contract is purchased by an employer for an employee under a plan which meets the requirements of section 404(a)(2) (whether or not the employer deducts the amounts paid for the contract under such section), the employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities).

* * * * *

[Sec. 403(a) as amended by sec. 23(b), Technical Amendments Act 1958 (72 Stat. 1622); by sec. 4(d), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 825); sec. 232(e)(4), Rev. Act 1964 (78 Stat. 111)]

PAR. 16. Paragraph (b) of § 1.403(a)–1 is amended to read as follows:

§ 1.403(a)–1 Taxability of beneficiary under a qualified annuity plan.

* * * * *

(b) The amounts received by or made available to any employee referred to in paragraph (a) of this section under such annuity contract shall be included in gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities), except that certain total distributions described in section 403(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see § 1.403(a)–2. However, for taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

* * * * *

PAR. 17. Section 1.403(b) is amended by revising section 403(b)(1) and by revising the historical note. These amended provisions read as follows:

§ 1.403(b) Statutory provisions; taxation of employee annuities; taxability of beneficiary under annuity purchases by section 501(c)(3) organization or public school.

Sec. 403. *Taxation of employee annuities.* * * *

(b) *Taxability of beneficiary under annuity purchased by section 501(c)(3) organization*—(1) *General rule.* If—

(A) An annuity contract is purchased—

(i) For an employee by an employer described in section 501(c)(3) which is exempt from tax under section 501(a), or

(ii) For an employee (other than an employee described in clause (i)), who performs services for an educational institution (as defined in section 151(e)(4)), by an employer which is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing,

(B) Such annuity contract is not subject to subsection (a), and

(C) The employee's rights under the contract are nonforfeitable, except for failure to pay future premiums,

then amounts contributed by such employer for such annuity contract on or after such rights become nonforfeitable shall be excluded from the gross income of the employee for the taxable year to the extent that the aggregate of such amounts does not exceed the exclusion allowance for such taxable year. The employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities).

* * * * *

[Sec. 403(b) as added by sec. 23(a), Technical Amendments Act 1958 (72 Stat. 1620) and amended by sec. 3, Act of October 4, 1961 (Pub. Law 87-370, 75 Stat. 801); sec. 232 (e)(5), Rev. Act 1964 (78 Stat. 111)]

PAR. 18. Paragraph (c)(1) of § 1.403(b)-1 is amended to read as follows:

§ 1.403(b)-1 Taxability of beneficiary under annuity purchased by a section 501(c)(3) organization or public school.

* * * * *

(c) *Taxation of amounts received under annuity contracts*—(1) *In general.* The amounts received by or made available to any employee under an annuity contract to which paragraph (a) or (b) of this section applies shall be included in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to any amount received by or made available to any such employee under such an annuity contract. For taxable years beginning after December 31, 1963, amounts received or made available to any such employee under such annuity contract may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

* * * * *

PAR. 19. Section 1.403(c) is amended by revising section 403(c) and by revising the historical note. These amended provisions read as follows:

§ 1.403(c) Statutory provisions; taxation of employee annuities; taxability of beneficiary under a nonqualified annuity.

Sec. 403. *Taxation of employee annuities.* * * *

(c) *Taxability of beneficiary under a nonqualified annuity.* If an annuity contract purchased by an employer for an employee is not subject to subsection (a) and the employee's rights under the contract are nonforfeitable, except for failure to pay future premiums, the amount contributed by the employer for such annuity contract on or after such rights become nonforfeitable shall be included in the gross income of the employee in the year in which the amount is contributed. The employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities).

* * * * *

[Sec. 403(c) as relettered by sec. 23(a), Technical Amendments Act 1958 (72 Stat. 1620) and amended by sec. 232(e)(6), Rev. Act 1964 (78 Stat. 111)]

PAR. 20. Section 1.403(c)-1 is amended by revising paragraphs (a) and (b). These amended provisions read as follows:

§ 1.403(c)-1 Taxability of beneficiary under a nonqualified annuity.

(a) Except as provided in section 402(d), if an employer purchases an annuity contract and if the amounts paid for the contract are not subject to paragraph (a) of § 1.403(a)-1 or paragraph (a) of § 1.403(b)-1, the amount of such contribution shall, to the extent it is not excludable under paragraph (b) of § 1.403(b)-1, be included in the income of the employee for the taxable year during which such contribution is made if, at the time the contribution is made, the employee's rights under the annuity contract are nonforfeitable, except for failure to pay future premiums. If the annuity contract was purchased by an employer which is not exempt from tax under section 501(a) or section 521(a), and if the employee's rights under the annuity contract in such a case were forfeitable at the time the employer's contribution was made for the annuity contract, even though they became nonforfeitable later, the amount of such contribution is not required to be included in the income of the employee at the time his rights under the contract become nonforfeitable. On the other hand, if the annuity contract is purchased by an employer which is exempt from tax under section 501(a) or section 521(a), all or part of the value of the contract may be includible in the employee's gross income at the time his rights under the contract become nonforfeitable (see section 403(d) and the regulations thereunder). As to what constitutes nonforfeitable rights of an employee, see § 1.402(b)-1. The amounts received by or made available to the employee under the annuity contract shall be included in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). For rules relating to the treatment of employer contributions as part of the consideration paid by the employee, see section 72(f). See also section 101(b)(2)(D) for rules relating to the treatment of the limited exclusion provided thereunder as part of the consideration paid by the employee.

(b) If an employer has purchased annuity contracts and transferred the same to a trust or if an employer has made contributions to a trust for the purpose of providing annuity contracts for his employees as provided in section 402(d) (see paragraph (a) of § 1.402(d)-1), the amount so paid or contributed is not required to be included in the income of the employee, but any amount received by or made available to the employee under the annuity contract shall be includible in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to any amount received by or made available to the employee under the annuity contract. For taxable years beginning after December 31, 1963, amounts received by or made available to the employee under the annuity contract may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). In such case the amount paid or contributed by the employer shall not constitute consideration paid by the employees for such annuity contract in determining the amount of annuity payments required to be included in his gross income under section 72 unless the employee has paid income tax for any taxable year beginning before January 1, 1949, with respect to such payment or contribution by the employer for such year and such tax is not credited or refunded to the employee. In the event such tax has been paid and not credited or refunded the amount paid or contributed by the employer for such year shall constitute consideration paid by the employee for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under section 72.

* * * * *

PAR. 21. Section 1.5 is amended by revising section 5(b) and by adding a historical note. These amended and added provisions read as follows:

§ 1.5 Statutory provisions; cross references relating to tax on individuals.

Sec. 5. *Cross references relating to tax on individuals.* * * *

(b) *Special limitations on tax.* (1) For limitation on surtax attributable to sales of oil or gas properties, see section 632.

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

(3) For limitation on tax where an individual chooses the benefits of income averaging, see section 1301.

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

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

[Sec. 5 as amended by sec. 232(f)(2), Rev. Act 1964 (78 Stat. 111)]

PAR. 22. Section 1.1-3 is amended to read as follows:

§ 1.1-3 Limitation on tax.

The tax imposed by section 1 (whether by subsection (a) or 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 gains over net short-term capital losses. Where, for purposes of computations under the income averaging provisions, section 1201 (b) is treated as imposing the alternative tax on capital gains computed under section 1304(e)(2), the 87-percent limitation shall apply only to the tax equal to the tax imposed by section 1, reduced by the amount of the tax imposed by section 1 which is attributable to capital gain net income for the computation year.

PAR. 23. Paragraph (b)(3) of § 1.691(a)-3 is amended to read as follows:

§ 1.691(a)-3 Character of gross income.

* * * * *

(b) * * *

(3) If the amounts received would be subject to special treatment under part I (section 1301 and following), subchapter Q, chapter 1 of the Code, relating to income attributable to several taxable years, as in effect for taxable years beginning before January 1, 1964, if the decedent had lived and included such amounts in his gross income, such sections apply with respect to the recipient of the income.

* * * * *

PAR. 24. Paragraph (c)(1)(ii) of § 1.702-1 is amended to read as follows:

§ 1.702-1 Income and credits of partner.

* * * * *

(c) Gross income of a partner.

(1) * * *

(ii) In determining the application of the provisions permitting the spreading of income for services rendered over a 36-month period (section 1301, as in effect for taxable years beginning before January 1, 1964);

* * * * *

PAR. 25. Paragraph (c)(1) of § 1.1235-1 is amended to read as follows:

§ 1.1235-1 Sale or exchange of patents.

* * * * *

(c) *Special rules*—(1) *Payments for infringement.* If section 1235 applies to the transfer of all substantial rights to a patent (or an undivided interest therein), amounts received in settlement of, or as the award of damages in, a suit for compensatory damages for infringement of the patent shall be considered payments attributable to a transfer to which section 1235 applies to the extent that such amounts relate to the interest transferred. For taxable years beginning before January 1, 1964, see section 1304, as in effect before such date, and § 1.1304a-1 for treatment of compensatory damages for patent infringement.

* * * * *

PAR. 26. Paragraph (a) of § 1.6012-1 is amended by revising subparagraph (7)(ii) (*j*) and (*k*), by adding a new subparagraph (7)(ii)(*l*), and by revising subparagraph (7)(viii). These amended and added provisions read as follows:

§ 1.6012-1 Individuals required to make returns of income.

(a) *Individual citizen or resident.* * * *

(7) *Use of Form 1040A by certain taxpayers with gross income less than $10,000* * * *

(ii) *Restrictions on use of Form 1040A.* * * *

(*j*) Who claims a deduction for an exemption upon a multiple support agreement under section 152(c);

(*k*) Who claims credit for payment of estimated income tax or for an overpayment of income tax for the previous taxable year; or

(*l*) Who chooses to have the benefits of income averaging for the taxable year.

* * * * *

(viii) *Joint return of husband and wife on Form 1040A.* A husband and wife, eligible under section 6013 and the regulations thereunder to file a joint return for the taxable year, may, subject to the provisions of this subparagraph, make a joint return on Form 1040A for any such year in which the aggregate gross income of the spouses is less than $10,000, consists entirely of remuneration for services performed as an employee, dividends, or interest, and does not include more than $200 from dividends, interest, and remuneration other than wages as defined in section 3401(a). For purposes of determining whether gross income from sources to which the $200 limitation applies exceeds such amount in cases where both spouses receive dividends from domestic corporations, the amount of such dividends received by each spouse is taken into account to the extent that such dividends are includible in gross income. See section 116 and §§ 1.116-1 and 1.116-2. If a joint return is made by husband and wife on Form 1040A, the liability for the tax shall be joint and several. Form 1040A shall not be used by a husband and wife for any taxable year for which they choose to have the benefits of income averaging.

* * * * *

PAR. 27. Section 1.1301 which follows the heading "Income Attributable to Several Taxable Years" is amended by revising its heading and by adding a historical note. These amended and added provisions read as follows:

§ 1.1301a Statutory provisions; compensation from an employment.

* * * * *

[Sec. 1301 as in effect prior to amendment by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

PAR. 28. Section 1.1301-1 is amended to read as follows:

§ 1.1301a-1 Introduction and effective date.

(a) Part I (section 1301 and following), subchapter Q, chapter 1 of the Code, provides special rules to relieve a taxpayer from the amount of tax which otherwise results when an amount of income which has been earned over a period of years is received or accrued in 1 taxable year. Because of the graduated income tax rates this so-called bunching of income in 1 year usually subjects it to a higher rate of tax than would be payable if it had been received or accrued over the several years during which it was earned. The statutory provisions of such part I mitigate the tax consequences of such bunching of income by placing a limit upon the amount of tax to be paid for the taxable year in which such income is received or accrued. In effect, these sections generally treat the income as having been included in gross income ratably over the years (preceding receipt or accrual) in which it was earned. However, these sections have no effect on the income tax liability for prior taxable years; they simply provide a special method of computing the amount of tax for the year of receipt or accrual.

(b) Except as otherwise provided in § 1.1301a-3 and § 1.1307a-3, part I (section 1301 and following), subchapter Q, chapter 1 of the Code (relating to income attributable to several taxable years), shall not apply to taxable years beginning after December 31, 1963.

PAR. 29. The heading of § 1.1301-2 is amended to read as follows:

§ 1.1301a-2 Compensation from an employment.

PAR. 30. The following new section is inserted following § 1.1301a-2:

§ 1.1301a-3 Applicability to taxable years after December 31, 1963.

(a) Section 1301 is applicable to a taxable year beginning after December 31, 1963, if—

(1) An individual or a partnership receives or accrues compensation from an employment (as defined in section 1301(b) and the regulations thereunder) which began before February 6, 1963, and

(2) The taxpayer elects, in accordance with paragraph (b) of this section, to compute the tax attributable to such compensation under the provisions of sections 1301 and 1307, as in effect for taxable years beginning before January 1, 1964.

A taxpayer who makes such an election for a taxable year may not choose the benefits provided by part I of subchapter Q of chapter 1 of the Code (relating to income averaging) for that taxable year.

(b) Such election is signified by computing tax under the provisions of sections 1301 and 1307 on his return. The taxpayer may make or change his election at any time before the expiration of the period (including extensions thereof) prescribed in section 6511 for making a claim for credit or refund of the tax imposed by chapter 1 for such taxable year. However, such period is not extended by the right to make or change such election.

PAR. 31. Section 1.1302 is amended by revising its heading and by adding a historical note. These amended and added provisions read as follows:

§ 1.1302a Statutory provisions; income from an invention or artistic work.

* * * * *

[Sec. 1302 as in effect prior to amendment by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

PAR. 32. Section 1.1302–1 is amended by revising its heading, by revising paragraph (d) (2) and (3), and by adding a new paragraph (e). These amended and added provisions read as follows:

§ 1.1302a–1 Income from an invention or artistic work.

* * * * *

(d) *Computation of tax.* * * *

(2) For effect of allocation of income on items based on amount of income and with respect to a net operating loss or a capital loss carryover, see paragraph (d) (2) of § 1.1301a–2.

(3) See paragraph (d) (4) of § 1.1301a–2 for the computations which are necessary when an amount of gross income from an invention or artistic work is allocated to a period to which there has also been allocated other income entitled to the benefits of part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

(e) *Effective date.* Section 1302 and this section shall not apply to taxable years beginning after December 31, 1963.

PAR. 33. Section 1.1303 is amended by revising its heading, by adding a paragraph (4) to section 1303(b), and by adding a historical note. These amended and added provisions read as follows:

§ 1.1303a Statutory provisions; income from back pay.

Sec. 1303. *Income from back pay.* * * *

(b) *Definition of back pay.* * * *

(4) Termination payments under section 5(c) or section 6(1) of the Peace Corps Act which are received or accrued by an individual during the taxable year on account of any period of service, as a volunteer or volunteer leader under the Peace Corps Act, occurring prior to the taxable year.

[Sec. 1303 as amended by sec. 201, Peace Corps Act (Pub. Law 87–293, 75 Stat. 625); as in effect prior to amendment by sec. 232 (a), Rev. Act 1964 (78 Stat. 105)]

PAR. 34. Section 1.1303–1 is amended by revising its heading, by revising paragraph (d) (2) and (3), and by adding a new paragraph (e). These amended and added provisions read as follows:

§ 1.1303a–1 Income from back pay.

* * * * *

(d) *Computation of tax.* * * *

(2) For effect of allocation of income on items based on amount of income and with respect to a net operating loss or a capital loss carryover, see paragraph (d) (2) of § 1.1301a–2.

(3) See paragraph (d) (4) of § 1.1301 a–2 for the computations which are necessary when an amount of back pay is allocated to a period to which there has also been allocated other income entitled to the benefits of part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

* * * * *

(e) *Effective date.* Section 1303 and this section shall not apply to taxable years beginning after December 31, 1963.

PAR. 35. Section 1.1304 is amended by revising its heading and by revising the historical note. These amended provisions read as follows:

§ 1.1304a Statutory provisions; compensatory damages for patent infringement.

* * * * *

[Sec. 1304 as added by sec. 1, Act of Aug. 11, 1955 (Pub. Law 366, 84th Cong., 69 Stat. 688); as in effect prior to amendment by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

PAR. 36. Section 1.1304–1 is amended by revising its heading and by revising paragraphs (d) (2) and (3) and (f). These amended provisions read as follows:

§ 1.1304a–1 Compensatory damages for patent infringement.

* * * * *

(d) *Computation of tax.* * * *

(2) For effect of allocation of income on items based on amount of income and with respect to a net operating loss or a capital loss carryover, see paragraph (d) (2) of § 1.1301a–2.

(3) See paragraph (d) (4) of § 1.1301a–2 for the computations which are necessary when an amount of compensatory damages is allocated to a period to which there has also been allocated other income entitled to the benefits of part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

* * * * *

(f) *Effective date of this section.* The provisions of section 1304 and this section shall be applicable with respect to taxable years ending after August 11, 1955, but only with respect to amounts of compensatory damages received or accrued after such date as the result of awards made after such date. Section 1304 and this section shall not apply to taxable years beginning after December 31, 1963.

* * * * *

PAR. 37. Section 1.1305 is amended by revising its heading and by revising the historical note. These amended provisions read as follows:

§ 1.1305a Statutory provisions; breach of contract damages.

* * * * *

[Sec. 1305 as added by sec. 1, Act of Aug. 26, 1957 (Pub. Law 85–165, 71 Stat. 413); as in effect prior to amendment by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

PAR. 38. Section 1.1305–1 is amended by revising its heading and by revising paragraphs (d) (3) and (4), (g), and (h). These amended provisions read as follows:

§ 1.1305a–1 Breach of contract damages.

* * * * *

(d) *Computation of tax.* * * *

(3) For effect of allocation of income on items based on amount of income and with respect to a net operating loss or a capital loss carryover, see paragraph (d) (2) of § 1.1301a–2.

(4) See paragraph (d) (4) of § 1.1301a–2 for the computations which are necessary when an amount of breach of contract damages is allocated to a period to which there has also been allocated other income entitled to the benefits of the provisions of part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

* * * * *

(g) *Applicability of another section under part I, subchapter Q, chapter 1 of the Code.* In any case where the amount involved in a particular breach of contract, or breach of a fiduciary duty or relationship, are also covered by the particular terms of another section in part I, subchapter Q, chapter 1 of the Code, the rules for such other section shall apply, since those sections are directed to more specific situations than the provisions of section 1305. Thus, if a taxpayer receives an amount representing damages awarded in a civil action for breach of contract, or breach of fiduciary duty or relationship, and such award also constitutes the payment of an amount which qualifies for treatment prescribed in section 1302 and the regulations thereunder, such amount shall be subject to the provisions of section 1302 and § 1.1302a–1, and section 1305 shall not apply.

(h) *Effective date of this section.* The provisions of section 1305 and this section apply with respect to taxable years ending after December 31, 1954, but only as to amounts received or accrued after such date as the result of awards made after such date. Section 1305 and this section shall not apply to taxable years beginning after December 31, 1963.

PAR. 39. Section 1.1305–2 is amended to read as follows:

§ 1.1305a–2 Illustrations.

The provisions of section 1305 and § 1.1305a–1 may be illustrated by the following examples:

Example (1). On December 31, 1957, a consent judgment is entered in favor of A, an accrual method taxpayer, for $500,000 damages to compensate him for the failure of the XYZ Company to pay royalties due him under the terms of a contract involving the operation by the XYZ Company of an oil lease. The court determined that the breach of contract covered the period from July 1, 1953, through December 31, 1957. The award of $500,000 includes $40,000 representing legal fees and court costs, and $460,000 representing compensation for loss of oil royalties for the period during which the contract was breached. Of the $460,000, the court determined that $110,000 was attributable to 1956 and $130,000 to January through October 1957. Information in the court records disclosed that $60,000 was attributable to 1955. A makes his income tax return on a calendar year basis. For purposes of determining the limitation on tax under section 1305, A must first compute the tax for 1957 under paragraph (d) (1) (i) of § 1.1305a–1 by including the entire amount of damages ($460,000) in gross income for such year and then compute the tax for 1957 without including the $460,000 in gross income in accordance with paragraph (d) (1) (ii) of such section. A must then compute the tax for the current year and all prior years to which the amount of the award is allocable pursuant to paragraph (d) (1) (iii) of § 1.1305a–1. In making such compensation, A must allocate $110,000 to 1956, $130,000 to the first 10 months of 1957, and $60,000 to 1955 in accordance with para-

graph (c)(1) of § 1.1305a–1. The remaining $160,000 of the $460,000 would be prorated over the unallocated 20 months, 2 in 1957, 12 in 1954, and 6 in 1953 or $8,000 per month in accordance with paragraph (c)(2) of § 1.1305a–1. Thus, the proper allocations would be $146,000 to 1957, $110,000 to 1956, $60,000 to 1955, $96,000 to 1954, and $48,000 to 1953. In addition A is entitled to a deduction for percentage depletion with respect to the amounts allocated to the current taxable year and to prior taxable years. For such purpose, A must reconstruct his gross income and taxable income from the property for 1957 and for the years 1953, 1954, 1955, and 1956. A is also entitled to all credits, deductions, or other items to which he would have been entitled had the royalties been received and included in the gross income in those years. Thus, if, for 1953, prior to the allocation of a part of the award to such year, A had no gains from the sale or exchange of capital assets and no taxable income and he had a capital loss carryover of $1,500 to such year, A may deduct $1,000 as a capital loss in computing the tax for 1953 as provided in paragraph (d)(1)(iii) of § 1.1305a–1. See sections 1211(b) and 1212 and the regulations thereunder.

Example (2). B, a cash method taxpayer, is the author of a play presented in New York City, Chicago, and San Francisco. The play ran from April 6, 1957, through December 27, 1959. In September 1959, B sues the producer, M, for breach of contract respecting the agreement entered into between M and B. M contends that under the terms of the contract B was entitled to a payment of $25,000 on the production of the play and royalties thereafter limited to its earnings in New York City. B insists that he is also entitled to royalties on the earnings of the two companies established by M to present the play in Chicago and San Francisco. On December 29, 1959, the court awards B the sum of $38,000 representing compensation for the loss of royalty income over the period during which the play was presented in Chicago and San Francisco, including legal fees and other costs. This award is paid to B in 1960. In its decree, the court designates royalty payments to B for such period (April 6, 1957, to December 27, 1959) of $1,000 per month or a total of $33,000 for the full period. Although B is entitled to the benefits of section 1305, he must first ascertain whether section 1302 applies, since the other sections under part I (section 1301 and following), subchapter Q, chapter 1 of the Code, have prior applicability. However, B determines that section 1302 is not applicable for the reason that he worked only 18 months on the play. For the purpose of section 1305(a) and paragraph (a) of § 1.1305a–1, B may allocate the $33,000 at the rate of $1,000 per month over the 33 months extending from April 1957 through December 1959. Upon receipt of the award and pursuant to agreement with his literary agent, B pays the agent $2,500 as agent's commission; had B received his royalties when due, he would have paid his agent $3,300 under his contract with the agent. In computing his taxable income for 1960 and for the years reflected in the period April 1957 through December 1959, B may, under the limitation prescribed in paragraph (d)(1) of § 1.1305a–1, deduct only $2,500 for commissions paid to his agent.

PAR. 40. Section 1.1306 is amended by revising its heading and by revising the historical note. These amended provisions read as follows:

§ 1.1306a Statutory provisions; damages for injuries under the antitrust laws.

* * * * *

[Sec. 1306 as added by sec. 58(a), Technical Amendments Act 1958 (72 Stat. 1646); as in effect prior to amendment by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

PAR. 41. Section 1.1306–1 is amended by revising its heading and by revising paragraphs (d) (2) and (3) and (e). These amended provisions read as follows:

§ 1.1306a–1 Damages for injuries under the antitrust laws.

* * * * *

(d) *Computation of tax.* * * *

(2) For the effect of allocation of income on items based on amount of income and with respect to a net operating loss or capital loss carryover, see paragraph (d)(2) of § 1.1301a–2.

(3) See paragraph (d)(4) of § 1.1301a–2 for the computations which are necessary when an amount of damages is allocated to a period to which there has also been allocated other income entitled to the benefits of part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

(e) *Effective date of this section.* The provisions of section 1306 and this section are applicable with respect to taxable years ending after September 2, 1958, but only with respect to amounts of damages received or accrued after such date as a result of awards or settlements made after such date. Section 1306 and this section shall not apply to taxable years beginning after December 31, 1963.

* * * * *

PAR. 42. Section 1.1307 is amended by revising its heading and by revising the historical note. These amended provisions read as follows:

§ 1.1307a Statutory provisions; rules applicable to part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

* * * * *

[Sec. 1307 as renumbered by sec. 1, Act of Aug. 11, 1955 (Pub. Law 366, 84th Cong., 69 Stat. 688); sec. 1, Act of Aug. 26, 1957 (Pub. Law 85–165, 71 Stat. 413); sec. 58, Technical Amendments Act 1958 (72 Stat. 1646); amended by sec. 22, Rev. Act 1962 (76 Stat. 1064); as in effect prior to amendment by sec. 232(a), Rev. Act 1964 (78 Stat. 105)]

PAR. 43. The heading of § 1.1307–1 is amended to read as follows:

§ 1.1307a–1 Rules applicable to part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

* * * * *

PAR. 44. Section 1.1307–2 is amended by revising its heading and by revising paragraphs (a)(3) and (c), and subparagraphs (2), (3), and (5)(ii) of the example in paragraph (e). These amended provisions read as follows:

§ 1.1307a–2 Election with respect to charitable contributions.

(a) *Introduction.* * * *

(3) If an election is made by a taxpayer to determine the limitation on tax on bunched income with the application of section 1307(e) and this section, then the computations required by sections 1301, 1302, 1303, 1304, 1305, 1306, and 1307 (a) to (d), and the regulations thereunder, shall be made with due regard to the requirements of section 1307(e) and this section. For example, with respect to compensation from an employment which is subject to the provisions of section 1301, the allocation required to be made by paragraph (c) of § 1.1301a–2 shall be made with due regard to the fact that the amount of the compensation must be reduced by the amount prescribed in paragraph (b) of this section; similarly, in making the computations required by paragraph (d)(2) of § 1.1301a–2, due regard must be given to the fact that the amount of bunched income which is to be included in adjusted gross income of a taxable year for the purpose of determining the maximum limitation prescribed by section 170(b)(1) for charitable contribution deductions is limited to the amount prescribed in paragraph (d) of this section.

* * * * *

(c) *Reduction of charitable contributions made in the current taxable year.* The portion of the charitable contributions made in the current taxable year which is required to be used as a reduction of the bunched income, as prescribed in paragraph (b) of this section, may not be taken into account as charitable contributions made during the current taxable year in making the computations for such taxable year prescribed by paragraph (d)(1)(iii) of §§ 1.1301a–2, 1.1302a–1, 1.1303a–1, 1.1304a–1, 1.1305a–1, and 1.1306a–1. Thus, in the situation exemplified in paragraph (b) of this section, where it is shown that the taxpayer made charitable contributions of $9,000 during the current taxable year, only $6,750 ($9,000—$2,250) may be taken into account as contributions actually made during such taxable year in the application of section 1307(e) and this section.

* * * * *

(e) * * *

Example. * * *

(2) *Reduction of bunched income.* The amount by which the employment compensation is to be reduced, pursuant to paragraph (b) of this section, is $3,000 computed as follows:

Employment compensation	$15,000
Adjusted gross income for 1962 (including the $15,000 employment compensation)	35,000
Maximum limitation under section 170(b)(1)(B)	7,000
Deduction allowable for 1962 (computed without regard to part I)	7,000
Amount of reduction ($7,000 × $15,000/$35,000)	3,000

Thus, $12,000 ($15,000 minus $3,000) is the portion of the employment compensation to be allocated equally over the 48-month period ($3,000 to each year) for purposes of paragraph (c) of § 1.1301a–2.

(3) *Reduction of charitable contributions made in 1962.* Pursuant to paragraph (c) of this section, the partial tax for 1962, that is, the tax attributable to the employment compensation allocated to 1962 computed as prescribed in paragraph (d)(1)(iii) of § 1.1301a–2, is determined as though B had made charitable contributions in 1962 of only $11,000 ($14,000 minus the $3,000 reduction).

* * * * *

(5) *Computation of taxable income.* * * *

(ii) The computation of taxable income pursuant to paragraph (d)(1)(iii) of

§ 1.1301a–2, with the application of section 1307(e), is as follows:

* * * * *

PAR. 45. The following new section is inserted after § 1.1307a–2:

§ 1.1307a–3 Effective date.

(a) Except as otherwise provided in paragraph (b) of this section, section 1307 is not applicable to taxable years beginning after December 31, 1963.

(b) If, for a taxable year beginning after December 31, 1963, a taxpayer elects under the provisions of § 1.1301a–3 to compute his tax in accordance with the provisions of sections 1301 and 1307 (as in effect for taxable years beginning before January 1, 1964), and also elects to have section 1307(e) apply, section 170 (b)(5) does not apply to charitable contributions paid in such taxable year.

[F.R. Doc. 66–5960; Filed, June 1, 1966; 8:50 a.m.]

Title 49—TRANSPORTATION

Chapter I—Interstate Commerce Commission

SUBCHAPTER A—GENERAL RULES AND REGULATIONS

[2d Rev. S.O. 975; Amdt. 1]

PART 95—CAR SERVICE

Railroad Operating Regulations for Freight Car Movement

At a session of the Interstate Commerce Commission held in Washington, D.C., on the 26th day of May A.D., 1966.

Upon further consideration of Second Revised Service Order No. 975 (31 F.R. 4802, 31 F.R. 5317, 31 F.R. 6058) and good cause appearing therefor:

It appearing, that for several years a number of railroads have published in the coal demurrage tariff, Freight Tariff 8–N, I.C.C. H–22, an exception which provides that during the 2 weeks prior to the miners' vacation period carloads of coal billed from mines or preparation plants with shipping instructions postdated to a date within the miners' vacation period may be moved from mines or preparation plant tracks for the convenience of the railroad and held free of demurrage until the shipping date shown on shipping instructions; that this arrangement is beneficial to the coal industry, to the receivers of coal, and to the railroads; that such holding would now be in violation of ICC Second Revised Service Order No. 975:

It is ordered, That:

(a) The provisions of § 95.975 *Railroad operating regulations for freight car movement* are suspended as to coal billed during the 2 weeks' period prior to the miners' vacation period from mines or preparation plants which will observe the vacation period and moved from these mines or preparation plant tracks with shipping instructions postdated to a date within the miners' vacation period in accordance with Item 238–A, Supplement 6 of Freight Tariff 8–N, ICC H–22.

(b) *Effective date.* This amendment shall become effective at 12:01 a.m., June 11, 1966.

(c) *Expiration date.* This amendment shall expire at 11:59 p.m., July 22, 1966, after which date all provisions of Second Revised Service Order No. 975 shall continue effective until its expiration date unless otherwise modified, changed, or suspended by order of this Commission.

(Secs. 1, 12, 15 and 17(2), 24 Stat. 379, 383, 384, as amended; 49 U.S.C. 1, 12, 15 and 17(2). Interprets or applies secs. 1(10–17), 15(4) and 17(2), 40 Stat. 101, as amended 54 Stat. 911; 49 U.S.C. 1(10–17), and 15(4) and 17(2))

It is further ordered, That a copy of this order and direction shall be served upon the Association of American Railroads, Car Service Division, as agent of all railroads subscribing to the car service and per diem agreement under the terms of that agreement; and that notice of this order be given to the general public by depositing a copy in the office of the Secretary of the Commission at Washington, D.C., and by filing it with the Director, Office of the Federal Register.

By the Commission.

[SEAL] H. NEIL GARSON, *Secretary.*

[F.R. Doc. 66–6026; Filed, June 1, 1966; 8:47 a.m.]

Title 43—PUBLIC LANDS: INTERIOR

Chapter II—Bureau of Land Management, Department of the Interior

SUBCHAPTER C—MINERALS MANAGEMENT (3000)

[Circular No. 2207]

PART 3120—OIL AND GAS

Subpart 3127—Continuation or Extension of Lease

CONTINUATION OF LEASE AS A RESULT OF ACTUAL DRILLING OPERATIONS

On page 11329 of the FEDERAL REGISTER of September 3, 1965, there was published a notice and text of a proposed amendment of 43 CFR 3127.2. The purpose of the amendment is to include in this section a definition of "actual drilling operations" as used in 30 U.S.C. sec. 266(e).

Interested persons were given 30 days within which to submit written comments, suggestions, or objections with respect to the proposed amendment. After consideration of all of the comments and suggestions received during that period the proposed definition has been amplified to include operations for testing, completing or equipping a well.

The proposed amendment with this change as set forth below is hereby adopted and shall become effective upon publication in the FEDERAL REGISTER.

§ 3127.2 Continuation of lease as a result of actual drilling operations.

(a) Any lease on which actual drilling operations, or for which under an approved cooperative or unit plan of development or operation, actual drilling operations were commenced prior to the end of its primary term and are being diligently prosecuted at that time, shall be extended for 2 years and so long thereafter as oil or gas is produced in paying quantities.

(b) Actual drilling operations must be conducted in such a way as to be an effort which one seriously looking for oil or gas could be expected to make in that particular area, given existing knowledge of geologic and other pertinent facts.

(c) As used in this section (1) "actual drilling operations" shall include not only the physical drilling of a well but the testing, completing or equipping of such well for the production of oil or gas; (2) "primary term" means all periods in the life of the lease prior to its extension by reason of production of oil or gas in paying quantities.

STEWART L. UDALL, *Secretary of the Interior.*

MAY 26, 1966.

[F.R. Doc. 66–6006; Filed, June 1, 1966; 8:45 a.m.]

Title 16—COMMERCIAL PRACTICES

Chapter I—Federal Trade Commission

PART 15—ADMINISTRATIVE OPINIONS AND RULINGS

Self-Locating Shopping Guide Promotional Program

§ 15.53 Self-locating shopping guide promotional program.

(a) The Federal Trade Commission has advised a sales promotion company that its proposed plan, to furnish self-locating shopping guides to wholesalers for redistribution to their competing retail customers, would not be objectionable provided that smaller retailers are able to obtain proportionally equal treatment.

(b) The Commission noted that some of the aspects of the plan are of interest only to relatively large retailers, and that it appears likely that some, at least, of a participating wholesaler's competing customers may be quite small retailers for whom the proposed plan would have little practical value.

(c) The Commission advised that the "statute requires that any services or facilities made available to the larger of two competing customers must be made proportionally available to the smaller."

(d) Assuming the existence of small competing customers, the Commission said, "it appears clear that if [the] plan is to conform to statutory requirements some provisions should be included therein which would provide for the needs of the smaller customers."

(38 Stat. 717, as amended; 15 U.S.C. 41–58; 49 Stat. 1526; 15 U.S.C. 13, as amended)

Issued: June 1, 1966.

By direction of the Commission.

JOSEPH W. SHEA, *Secretary.*

[F.R. Doc. 66–5993; Filed, June 1, 1966; 8:45 a.m.]