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Cumulative Bulletin

No. 1

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INCOME TAX RULINGS

Nos. 1-655, Inclusive

THE INCOME TAX RULINGS constitute a service of information from which taxpayers and their counsel may obtain the best available indication of the trend and tendency of official opinion in the administration of the income and profits tax provisions of the Revenue Acts. The rulings have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of law which has not been formally approved and promulgated by the Secretary of the Treasury. Each ruling embodies the administrative application of the law and Treasury Decisions to the entire state of facts upon which a particular case arises. It is especially to be noted that the same result will not necessarily be reached in another case unless all the material facts are identical with those of the reported case. As it is not always feasible to publish a complete statement of the facts underlying each ruling, there can be no assurance that any new case is identical with the reported case. As bearing out this distinction, it may be observed that the rulings published from time to time may appear to reverse rulings previously published.

Officers of the Bureau of Internal Revenue are especially cautioned against reaching a conclusion in any case merely on the basis of similarity to a published Income Tax Ruling, and should base their judgment on the application of all pertinent provisions of the law and Treasury Decisions to all of the facts in each case. The Income Tax Rulings should be used merely as aids in studying the law and the Treasury Decisions.

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The Income Tax Bulletin Service for 1920 consisting of Weekly Bulletins of income-tax rulings, Bimonthly Digests of rulings published in the Weekly Bulletins, and semiannual Cumulative Bulletins with the full rulings published in the previous six months Weekly Bulletins assembled under the various section and article numbers, can be obtained by the public by subscription, price $2 a year. Subscriptions should be sent to the Superintendent of Public Documents, Government Printing Office, Washington, D. C.

INTRODUCTION.

Special attention is directed to the statement on the front cover.

The Cumulative Bulletin, December, 1919, contains Treasury Decisions and rulings of general interest relating to income and profits taxes issued between April 1, 1919, and December 31, 1919. These include Treasury Decisions, Solicitor's Law Opinions, Solicitor's Memoranda, Advisory Tax Board Recommendations and Memoranda, Recommendations and Memoranda of the Committee on Appeals and Review, and office decisions.

The following abbreviations are used:

T. D.=Treasury Decision.
O.=Solicitor's Law Opinion.
S.=Solicitor's Memorandum.
T. B. R.=Advisory Tax Board Recommendation.
T. B. M.=Advisory Tax Board Memorandum.
A. R. R.=Committee on Appeals and Review Recommendation.
A. R. M.=Committee on Appeals and Review Memorandum.
O. D.=Office Decision.
A, B, C, etc.=Represent the names of individuals.
M, N, X, Y, Z, etc.=Represent the names of corporations, places, or businesses, according to context.
x is used to represent a certain number.
x dollars or $x is used to represent a sum of money. x preceded by a number (15x) represents an amount equal to the amount represented by x multiplied by the number preceding x.

The Cumulative Bulletin is to be used supplementary to Regulations 45. Thus, if a question arose in regard to depreciation of intangible property, the first step would be to look in the index of Regulations 45, which gives article 163. Under this article the subject "depreciation of intangible property" is treated, but if further research is desired, the investigator finds the number of the section of the 1918 law (ordinarily at the top of the page of the regulations; in this case §214) covering this subject. In the Cumulative Bulletin he will find the ruling under the same section number.

References to section and article numbers are to sections of the Revenue Act of 1918, and to Articles of Regulations 45 (final edition), unless otherwise stated.

Rulings are arranged in the numerical order of the sections of the Revenue Act of 1918 to which they relate. To assist taxpayers in locating rulings on the subjects covered by the various sections the following brief outline of the arrangement of the Revenue Act of 1918 is given:

Section 1 _______________ General definitions.
Sections 200 to 261 _______ Income tax.
Sections 300 to 337 _______ Excess profits and war profits tax.
Sections 1300 to 1408 _____ General administrative and miscellaneous.

The sections relating to income tax are as follows:

General provisions—

Section 200. Income tax definitions.
201. Dividends.
202. Basis for determining gain or loss.
203. Inventories.
204. Net losses.
205. Fiscal year with different rates.
206. Parts of income subject to rates for different years.

Individuals and corporations.

Subject of section.	Number of sections applicable to—					
	Individuals.	Partnerships and personal service corporations.	Estates and trusts—fiduciaries.	Nonresident aliens.	Domestic corporations.	Foreign corporations.
Special sections	220	218	219	217	231 240	231
Normal tax	210	....	210	210	230	230
Surtax	211	....	211	211	....	....
Net income	212 226	212 226	212 226	212 217 226	232 226	232 226
Gross income	213	213	213	213 (*c*)	233	233 (*b*)
Deductions	214	214 218 (*d*)	214 219(*b*)(*c*)	214 217	234	234
Items not deductible	215	215	215	215	235	235
Credits allowed against net income	216 218 219 226	216 218 226	216 219 226	216 217 226	226 236 239	226 239 236
Credit for taxes	221 (*d*) 222	221 (*d*) 222	221 (*d*) 222	221 (*d*) 222	238	....
Returns	223	224 239	225	217 223	239	239
Returns where accounting period changed	226	226	226	226	226	226
Time and place for filing returns	227	227	227	227	227 241	227 241
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Payment of tax at source	221	221	221	221	....	221 237

Administrative provisions—

Section 250. Payment of taxes.
251. Receipts for taxes.
252. Refunds.
253. Penalties, specific.
254. Returns of payments of dividends.
255. Returns of brokers.
256. Information at the source.
257. Returns to be public records.
258. Publication of statistics.
259. Collection of foreign items.
260. Citizens of United States possessions.
261. Porto Rico and Philippine Islands.

CONTENTS.

INCOME TAX RULINGS.

Title I.—GENERAL DEFINITIONS.

Section 1.—GENERAL DEFINITIONS.

Section 1, Article 1502: Association. 13–19–414. O. D. 236.

An organization, not incorporated, and not having any agreement with its members whereby a partnership exists, and whose members contribute amounts to further the operations in locating mines, is an association and should file an income tax return under the Revenue Act of 1918.

Section 1, Article 1504: Association distinguished from trust. 10–19–351. S–1068.
(Also Section 219, Article 341.)
(Also Section 230, Article 503.)

Consideration of the taxable status of trusts, for purposes both of the normal income tax, the excess profits tax, the capital-stock tax, and the stamp tax. (Act of Oct. 3, 1913, G (a); Revenue Act of 1916, secs. 10, 407; Revenue Act of 1917, secs. 200, 201, 807; Revenue Act of 1918, secs. 1, 219, 230, 301, 1000, 1107.)

The V Trust, W Trust Estate, X Trust, Y Trust, and Z Trust were organized under a declaration of trust. The general plan in each case was to transfer property to trustees for a specified period during which they had power to manage the property in the interest of the owners, whose rights were evidenced by certificates issued by the trustees. During the trust period the trustees might distribute such of the income as they saw fit, and at the end of the period they were to divide the property among the persons entitled. These are the general features in each case.

There are, however, important differences in the constitution of the above trusts by reason of which they fall into two classes.

I.

V Trust and W Trust Estate.

In these cases the trustees were appointed for definite periods; and the declaration of trust provides that the beneficiaries (termed "shareholders") shall hold annual meetings for the election of new trustees to fill the vacancies thus occurring. In this way the beneficiaries reserved to themselves control over the persons delegated to conduct their affairs; a voice in the business. A trust of this character is held to have the following taxable characteristics:

(1) *Normal income tax.*—Where the beneficiaries thus reserve a voice in the management of the affairs of the trust, it is held to constitute an "association," taxable as such under the provisions relating to the normal tax upon income in the various statutes. (Act of Oct. 3, 1913, G(a); Revenue Act of 1916, sec. 10; Revenue Act of 1918, secs. 1, 230.)

(2) *Excess profits tax.*—For the same reason these two trusts are, as "associations," subject to the excess profits tax imposed by the Revenue Act of 1917 and the Revenue Act of 1918. (Revenue Act of 1917, secs. 200, 201; Revenue Act of 1918, secs. 1, 301.)

(3) *Capital Stock Tax.* (See S. 1084.) These trusts are subject to capital stock tax under Revenue Act of 1916 and Revenue Act of 1918. Elliott *v.* Freeman, 220 U. S. 178, does not apply because of change in statute.

(4) *Stamp tax.*—This is imposed upon certificates issued by "associations"; and the certificates are consequently subject to tax both under the Revenue Act of 1917 and the Revenue Act of 1918. (Revenue Act of 1917, sec. 807, Sch. A, par. 3; Revenue Act of 1918, sec. 1; sec. 1107, Sch. A, par. 3.) The intention to include all organizations, whether incorporated or not, is emphasized by the description of the certificates in the Act of 1918, so as to include certificates "of profits, or of interest in property or accumulations."

II.

X Investment Trust, Y Credit Trust, and Z Credit Trust.

In these cases the trustees originally appointed were to hold office during the entire period of the trust, the right of the shareholders being limited to filling vacancies caused by death, resignation, or disability. In cases of this character the beneficiaries do not retain any substantial control over the affairs of the trust. They delegate their proprietary functions to others; and any further control on their part depends upon contingencies. Such cases come within the decision of the Supreme Court in Crocker *v.* Malley (Mar. 17, 1919). Such trusts are not "associations," or taxable as such. The result is indicated below. As none of these trusts were formed prior to the year 1918, it will be necessary to state the rules only with reference to the Revenue Act of 1918.

(1) *Normal income tax.*—These trusts are not taxable under the provisions of section 230 of the Revenue Act of 1918, but under section 219, relating to "trusts." Under section 219, however, the entire net income received by the trustees is taxable to them, and the tax should be paid by them, whether or not any part of the income is distributed to the shareholders. (See Regulations 45, art. 342.)

(2) *Excess profits tax.*—As these trusts are not taxable as "associations," they are not subject to the excess profits tax. (Revenue Act of 1918, secs. 1, 301.)

(3) *Capital-stock tax.*—For the same reason the trusts are not subject to the capital-stock tax. (Revenue Act of 1918, secs. 1, 1000.)

(4) *Stamp tax.*—For the same reason the certificates issued by the trustees are not subject to stamp tax. (Revenue Act of 1918, sec. 1107, Sch. A. par. 3.)

Section 1, Article 1504: Association distinguished from trust. 27–19–600. S. 1205.

INCOME TAX—SECTION II, PARAGRAPH G (A), ACT OF OCTOBER 3, 1913.

The M Company is not an association and consequently is not subject to income tax under the provisions of Section II, paragraph G (a), act of October 3, 1913.

Section II, paragraph G (a), act of October 3, 1913, provides in part as follows:

That the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation, joint-stock company, or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships, but if organized, authorized, or existing under the laws of any foreign country, then upon the amount of net income accruing from business transacted and capital invested within the United States during such year.

The M Company is a trust created by an agreement between the N Company and certain trustees. Under this agreement shares of stock in various companies were transferred to the trustees for the period of the lives of certain persons named therein and twenty years after the death of the survivor. The trustees, in accordance with this agreement, issued certificates of beneficial interest, each certificate stating the number of shares to which the person named therein was entitled, and each original beneficiary being entitled to receive a number of shares of the trust equal to the number of shares of stock in the O Company registered in his name. It was provided in the trust agreement that the trustees should be self-perpetuating, should have complete and absolute control of the property, including the power of sale and reinvestment of the proceeds. The rights of the certificate holders were expressly limited to receiving such distributions of net income or proceeds of the property as the trustees might declare. It was also provided that the trustees should in no event have recourse to the certificate holders in the payment of any expenses for any liability incurred by the trustees and that upon the expiration of the trust, the trustees should distribute ratably among the certificate holders all money remaining in their hands, and convey and transfer all property other than money to the N Company. The certificates were without par value and were in terms assignable on the books of the trustees by transfer in writing by the holder and surrender of the certificates.

The question as to whether a trust of this nature is taxable as an association, under the several acts enumerated, depends upon the extent of the powers reserved to the holders of the certificates of beneficial interest to regulate the management of the affairs of the trust. Where the beneficiaries do not retain any substantial control over the affairs of the trust, it is held not to be an association or taxable as such. In the instant case the certificate holders have no control whatsoever over the affairs of the trust.

The contention that the trustees are themselves an association is answered by Mr. Justice Holmes in his opinion in the case of Crocker *v.* Malley, 249 U. S. 223, where, at page 234, he says in part as follows:

* * * The trustees by themselves can not be a joint-stock association within the meaning of the act unless all trustees with discretionary powers are such, and the special provision for trustees in D is to be made meaningless.

It is therefore held that the M Company is not an association and consequently is not subject to income tax under the provisions of Section II, paragraph G (a), act of October 3, 1913.

Section 1, Article 1505: Limited partnership as partnership. 20–19–501. S. 1160.

Income tax: Act of October 3, 1913, and act of September 8, 1916.

A limited partnership organized under the laws of Mississippi (secs. 5467–5484, Henningway's Ann. Miss. Code (1917)) is not taxable as an association on its income under the act of October 3, 1913, nor under the act of September 8, 1916.

The question has been asked as to whether the M Company is taxable as an association or as a partnership for the years 1915, 1916, and 1917.

Section II G (a) of the act of October 3, 1913, provides in part:

That the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation, joint-stock company, or association * * * not including partnerships.

Section 10 of the Revenue Act of 1916 provides in part:

That there shall be levied, assessed, collected, and paid annually upon the total net income arising in the preceding calendar year from all sources by every corporation, joint-stock company, or association, * * * but not including partnerships, a tax of 2 per centum upon such income; * * *

It appears that A, B, and C organized as a limited partnership under the laws of Mississippi, A and B being listed as general partners and C as a special partner, for a business to be carried on in the name of the "M Company." The question now is whether this limited partnership is of the type authorized by the statutes of Pennsylvania and to be classified as a corporation, or of the type authorized by the statutes of New York and to be treated as an ordinary common-law partnership for the years 1915, 1916, and 1917, the limited partnership not having been formally dissolved in accordance with the statute until 1917.

Partnerships authorized by the statutes of Pennsylvania and a few other States offer opportunity for limiting the liability of all of the members, provide for the transferability of shares, with the power of suing and being sued in the common name and are properly classified as joint-stock associations (Law Opinion 500; see also art. 1506, Reg. 45.) On the other hand, limited partnerships authorized by the statutes of New York and many other States do not afford limited liability to the general partners, although the special partners enjoy limited liability under certain conditions. Such partnerships do not sue in the partnership name and are generally so like ordinary common-law partnerships that they should be treated as such. (Law Opinion 500; see also Reg. 45, art. 1505.)

An examination of the laws of Mississippi (Henningway's Ann. Miss. Code (1917), secs. 5467–5484) shows that they are similar to the New York laws and that general partners are not afforded a limited liability although special partners do enjoy limited liability under certain conditions; that limited partnerships in Mississippi do not sue in the partnership name and are in general so like common-law partnerships that they should be treated as such.

It is therefore held that a limited partnership organized under the laws of Mississippi (secs. 5467–5484, Henningway's Ann. Miss. Code (1917)) is not taxable as an association on its income under the act of October 3, 1913, nor under the act of September 8, 1916.

Section 1, Article 1506: Limited partnership as corporation. 27–19–601. T. D. 2943.

Article 1506 of Regulations 45 is hereby amended to read as follows:

ART. 1506. *Limited partnership as corporation.*—On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships and must make returns of income and pay the tax as corporations. The income received by the members out of the earnings of such limited partnerships will be treated in their personal returns in the same manner as distributions on the stock of corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. A Michigan partnership association is a corporation. Such a corporation may or may not be a personal-service corporation. See sections 200 and 218 of the statute and articles 1523–1532.

Section 1, Article 1506: Limited partnership as corporation. 29–19–621. O. D. 334.

Virginia partnership associations or limited partnerships formed under sections 2878 to 2886, inclusive, of the Virginia code of 1904, are to be treated as corporations or joint-stock companies for income tax purposes.

The status of Virginia limited partnerships formed under the act of March 14, 1918 (acts of Assembly of Virginia, 1918), must be determined in each case by consideration of the certificate of partnership and all pertinent facts.

Section 1, Article 1507: Joint ownership and joint adventure. 2–19–139. O. D. 96.

Participation of two United States corporations in a joint enterprise does not constitute them partners, and they are taxable under the Revenue Act of 1918 as corporations on their respective shares of the profits in the same way and to the same extent as on any other income acruing to them.

The same rule would apply in the case of a joint venture entered into by agreement between a United States corporation and an individual.

21-19-519.
Section 1, Article 1510: Government contract. O-916A.

INTERPRETATION OF THE TERM "GOVERNMENT CONTRACT," AS USED IN THE ACT.

1. The term "Government contract," as used in the act, is sufficiently broad to include oral or written contracts and those relating to sales of standard goods and services at open-market prices as well as those of a special nature.
2. Sales of goods, from existing stocks where delivery is immediate, are not, however, within the purview of the act.

The question arises as to whether the term "Government contract," as used in the act of February 24, 1919, is intended to include the filling of an order at open-market rates for standard goods and services if such contract is made with the Government, or for its benefit, between April 6, 1917, and November 11, 1918.

Section 1 of the act of February 24, 1919, provides in respect to the term "Government contract," when used in the act:

> The term "Government contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a contractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive," when applied to a contract of the kind referred to in clause (a) of this paragraph, includes all such contracts, which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.

The term occurs in numerous instances throughout the act. (Secs. 200, 240, 301 second bracket (*c*), 311 (*d*), 327, 1308.) By these provisions it is apparent that the purpose of the act is to tax to the fullest extent corporations deriving a large percentage of their profits from dealing with the Government.

While the word "contract" is a legal term, its use is not such an exclusive one as to bring it within the class of technical terms which are ordinarily construed so that they are given their strictly technical import. As it is a term in popular use, it is proper to construe it under the familiar rule that words in a statute are to be construed in their ordinary and usual meaning. (36 Cyc. 1114.) Reference to various definitions discloses the fact that the word "contract," while it does not wholly exclude the idea of a present completed transaction, ordinarily imparts the idea of an executory rather than an executed agreement. (Bouvier's Law Dictionary, "Words and Phrases.")

In the Dartmouth College case (4 Wheat., 518, 656), a contract is defined as:

> A transaction between two or more persons, in which each party comes under an obligation to the other, and each reciprocally acquires a right to whatever is promised by the other.

The ideas of obligation and the acquisition of a right necessarily involve something to be done in the future. So, too, the words "promise" and "engage," common in various definitions, imply futurity.

An executed contract, such as a sale where the goods are immediately appropriated to the contract and delivered, while technically a contract, is not therefore such a transaction as is ordinarily referred to as a contract, either in common parlance or in the language of the courts.

In so far, then, as sales of goods from existing stocks at market prices involve deliveries within such a reasonably short time as may be said to be immediate they do not constitute Government contracts within the meaning of the act.

No general exception can be made, however, in favor of orders, whether oral or written, at market prices on standard goods. Where the letter of a statute is departed from, it is in cases where an adherence to the exact phraseology of the act would lead to injustice, result in absurdity, or create a result obviously unintended.

Holy Trinity Church *v.* United States, 143 U. S., 457.
Lau Ow Bew *v.* United States, 144 U. S., 47.
Hawaii *v.* Mankichi, 190 U. S., 197.
Taylor *v.* United States, 207 U. S., 125.
American Security Co. *v.* District of Columbia, 224 U. S., 491.

No such situation is presented by the question here involved. No mere failure to provide for contingencies which it may seem wise to have specifically provided for justifies any addition to a statute by way of interpretation. (United States *v.* Goldenberg, 168 U. S., 95.) Nor can an exception be read into a statute where omitted by the legislative body. (United States *v.* Trans-Missouri Freight Assn., 166 U. S., 290.)

If goods are sold (not for immediate delivery) between the dates specified in the act to or for the use of the Government, there appears to be no ground for holding that such sales are not Government contracts within the meaning of the statute, even though the orders are for standard goods and are filled at market prices. Whether or not the terms are evidenced by writing is immaterial. Where the profits derived from these sales constitute 50 per cent of the business of the taxpayer, or as provided in section 301 (*b*) (*c*), where such profits exceed $10,000 for the taxable year, the special treatment provided for income from Government contracts will apply to such sales.

It is held therefore that no interpretation of the language of the statute is warranted by which a general distinction may be drawn between orders filled at market prices on standard goods and services and special Government contracts, but that transactions which involve sales of goods from existing stocks at market prices where delivery is immediate, are not "Government contracts" within the meaning of the law.

Section 1, Article 1510: Government contract. 12–19–394.
O. D. 224.

A contract entered into May 1, 1918, with the Director General of Railroads for certain cars for the account, use, and benefit of the various railroad companies under Federal control is not a Government contract within the meaning of sections 1 and 1408 of the Revenue Act of 1918, for the reason that the cars are not for the use of or for the account of the United States.

Section 1, Article 1510: Government contract. 17-19-468.
O. D. 261.

Contracts entered into between a taxpayer and the Knights of Columbus or the Young Men's Christian Association are not considered Government contracts within the meaning of section 1 of the Revenue Act of 1918. However, contracts with the American Red Cross are considered Government contracts within the meaning of that section.

Section 1, Article 1510: Government contract. 24-19-557.
(Also Section 301, Article 714.) O. D. 295.

A Government contract entered into in 1917, amended as to some of its provisions in 1918, and further modified in 1919, is in effect the same contract as entered into in 1917 if the original contract has not been revoked or supplanted by a new contract. Therefore income derived from the contract would be subject to the provisions of subdivision (c) of section 301.

Title II.—INCOME TAX.

Part I.—General Provisions.

Section 200.—DEFINITIONS.

Section 200, Article 1523: Personal service corporation. **1–19–135. T. B. M. 9.**

A claim for assessment as a personal service corporation should be denied where the income of the corporation is derived entirely as a result of the ownership of certain property (such as patents) and is in no sense derived from the personal activities of any of the stockholders.

Section 200, Article 1523: Personal service corporation. 29–19–622. A. R. R. 7.

Ruling under Revenue Act of 1917.

A freight-forwarding business which advances various costs of carriage is not to be classed as a corporation with nominal capital under the provisions of section 209, revenue act of 1917.

The M Company has appealed from the ruling of the income-tax unit that its business does not fall within the scope of section 209 of the revenue act of 1917.

This corporation is engaged in the business of forwarding freight. It maintains branch offices in addition to the home office. On January 1, 1917, the capital stock was 5x dollars and the surplus x dollars. Corrected taxable income for 1917 was 3x dollars. The balance sheets show the following amounts as to accounts receivable and accounts payable:

	Dec. 31, 1916.	Dec. 31, 1917
Accounts receivable	5x dollars	19x dollars.
Accounts payable	4x dollars	22x dollars.

Invoices forwarded with the correspondence of the corporation show that the income is from other sources than commissions. These also indicate that the corporation customarily advances the necessary costs of transportation for the individuals and concerns with whom business is done.

It would seem that the income of this corporation is largely derived from the employment of capital. It is probable that the advancing of costs of transportation is a necessary part of the business. These advances appear to be regularly and customarily made. Its letter discloses that the volume of business done during 1917 aggregated 244x dollars, from which there was derived a gross income reported of 17x dollars. These facts indicate that the use of capital in this business is not an incidental or minor factor but that the earnings may be attributed largely to the employment of capital.

Accordingly, the ruling that this corporation is not to be classed as a corporation with nominal capital within the provisions of section 209 of the Revenue Act of 1917, is sustained.

Section 200, Article 1524: Personal service corporation: certain corporations excluded. 1–19–4. O. D. 1.

Section 200 of the Revenue Act of 1918 excludes from personal-service classification a corporation 50 per cent or more of whose gross income consists of gains, profits, or income derived from trading as a principal. It does not necessarily follow, however, that if 50 per cent or more of the gross income was derived from the personal-service phase of the business, that the corporation may claim personal service classification.

Section 200, Article 1525: Personal services rendered by personal service corporation. 19–19–492. T. B. R. 58.
(Also Section 327, Article 901.)

Ruling under Revenue Act of 1917.

The M Company appealed to the Advisory Tax Board to be taxed under section 209 of the act of October 3, 1917, and as a personal service corporation under the Revenue Act of 1918.

The facts appear to be as follows:

The M Company is a corporation engaged in the business of retailing, and the return under consideration is for the fiscal year ended June 30, 1918. The stock of this corporation is owned by two stockholders who are actively engaged in the business and are the principal salesmen. There is but one other salesman employed by the corporation, and he works on a commission basis. The claim filed by this corporation sets forth the fact that the employment of capital is unnecessary in the business, except in paying for merchandise consigned to claimant by the factory and for the payment of the freight charges assessed thereon. The claim also shows how the direct use of the capital of the corporation can be avoided by having the purchaser make the customary deposit when placing his order and the funds thus secured would enable the corporation to transact business without the use of its own capital, no stock being carried other than that passing through the shop for test before delivery. The statements made by the corporation show that capital is necessary in the conduct of the business. The nature of the business is also well known and the statements made in the claim clearly establish the fact that the business conducted by this corporation is purely a commercial enterprise. Section 209 was not intended to apply to a commercial business, even though the capital used should be small in amount, and the definition of a personal-service corporation in section 200 of the Revenue Act of 1918 excludes any corporation 50 per cent or more of whose gross income consists of gains, profits, or income derived from trading as a principal.

Article 71 of Regulations No. 41 provides:

Section 209 * * * applies primarily to occupations, professions, trades, and businesses engaged principally in rendering personal service in which the employment of capital is not necessary and the earnings of which are to be ascribed primarily to the activities of the owners.

While the business of the M Company is evidently commercial it is of a nature, however, wherein salesmanship largely governs the volume of business, and in this case the two stockholders are actively engaged as salesmen for the corporation; and, while the income of the corporation is derived from purchase and sale, the volume of business would appear to rest practically upon the individual efforts of the two stockholders.

The examination of a number of returns of similar concerns indicates that many of them belong in section 210 of the act of October 3, 1917, and section 328 of the Revenue Act of 1918. The data on which a recommendation with respect to assessment under sections 210 and 328 might be based was not transmitted to the Advisory Tax Board, but in numerous cases where a commercial business is dependent upon the personal efforts of the stockholders and but a nominal capital is used, assessment has been so made.

The Advisory Tax Board, therefore, recommends that the decision of the Income Tax Unit declining to consider the claim of the M Company for taxation for the year 1917 under section 209 of the act of October 3, 1917, and for the year 1918 as a personal-service corporation, be sustained, and that the return of the corporation be examined with the view of determining whether assessment should be made under sections 210 and 328 of the 1917 and 1918 Revenue Acts, respectively.

Section 200, Article 1526: Personal services rendered by personal-service corporation: more than one business. 1–19–5. O. D. 2.

A sanitarium owned and conducted by doctors who, in addition to selling their services, derive income from the buildings and grounds by housing patients, can not be termed a corporation within the personal-service class.

Section 200, Article 1533: "Taxable year," "withholding agent" and "paid." 1–19–3. S–930.

The first taxable year of a corporation organized in 1918 which established a recognized fiscal year not ending in 1918 after its organization, is its fiscal year ending in 1919.

For instance, if a corporation was organized in March, 1918, and established its fiscal year ending January 31, its "first taxable year" under the Revenue Act of 1918 would be its fiscal year ending January 31, 1919, and its first return should be made to cover the period from its organization in March, 1918, to January 31, 1919.

Section 201.—DIVIDENDS.

Section 201, Article 1541: Dividends. 25-19-579. O-932.

INCOME TAX—SECTION 2(A) OF THE REVENUE ACT OF 1916.

A stockholder who has received payments from a corporation because of his stock ownership in such corporation, which payments were not subject to a formal declaration of dividends at the time they were made, and which were not then entered on the corporation's books against surplus accrued prior to March 1, 1913, is required to return such distribution of corporate profits as dividends and pay the income tax thereon pursuant to article 107, Regulations 33 (Revised) and T. D. 2659.

The formal declaration of such dividend by the directors of the corporation at a date one year after the dividend had been paid and subsequent entries made on the books of the corporation do not have the effect of relieving the taxpayer of tax on such dividends.

M is a corporation organized for the purpose of maintaining and operating a store. A, the taxpayer, owns all of the stock with the exception of a few qualifying shares. Moneys are paid to the taxpayer from time to time as he requests same. On March 1, 1913, the corporation had a surplus of 5x dollars. Prior to 1916 no mention is made upon the books of the corporation of any declarations of dividend. During 1916 the taxpayer received the sum of x dollars from the corporation as a division of profits. In making up his return for 1916 the taxpayer excluded said profit so received by him, claiming that it was a dividend declared from surplus accrued prior to March 1, 1913. No entry was made on the books of the corporation during the year in which these payments were received by the stockholder, indicating that such profits were made the subject of a formal declaration of dividend from the surplus accrued prior to March 1, 1913; that is to say, no charge was entered at the time this profit was paid against the surplus account as from surplus accrued prior to March 1, 1913, nor does there appear on the minutes of the directors' meetings any entry, prior to June, 1917, showing a declaration of dividend from the surplus accrued prior to March 1, 1913. However, in February, 1917, the corporation notified the taxpayer by letter that the said x dollars received by him during 1916 was paid out of surplus on hand March 1, 1913. The directors of the corporation at a meeting in June, 1917, passed a resolution stating that the above-mentioned sum represented dividends declared from surplus earned prior to March 1, 1913. As late as September, 1917, no entry had been made on the books of account of this corporation showing that the dividend was declared from earnings accumulated prior to March 1, 1913. The action of the corporation and directors just described was taken after the taxpayer had learned that the following telegram, dated February 19, 1917, had been sent from this bureau:

> If a corporation now passes resolution specifying dividends paid in 1916 from surplus earned prior to March 1, 1913, resolution will be considered effective for income tax purposes.

The questions submitted for opinion in this case are as follows:

1. Are profits received in 1916 by a stockholder from a corporation which had a large earned surplus on March 1, 1913, to be considered

as earnings accrued since March 1, 1913, and subject to the income tax, when such profits were not the subject of a formal declaration of dividend at the time they were received and which were not then entered against surplus account on the corporation's books?

2. In such case, what is the effect for income tax purposes of a formal declaration by the directors of the corporation made at a considerable time after the division of profits that such profits are dividends from surplus accumulated prior to March 1, 1913, and not from current earnings?

3. In the same circumstances, what is the effect of an entry against the surplus account made at the time of such a declaration of dividend by the directors in determining the taxability of amounts received in such a division of profits?

I.

Are payments received in 1916 by a stockholder from a corporation which had a large earned surplus on March 1, 1913, to be considered as paid from earnings accrued since March 1, 1913, and subject to the income tax, when such profits were not the subject of a formal declaration of dividend at the time they were received and which were not then entered against surplus account on the corporation's books?

Section 2 (a) of the Revenue Act of 1916 provides, inter alia:

> * * * That the term "dividend" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, * * * out of its earnings or profits accrued since March 1, 1913, and payable to its shareholders, whether in cash or in stock of the corporation * * *.

To resolve the question above stated requires a determination whether a distribution of profits without formalities by a corporation to a stockholder is a dividend as contemplated by the act, and, if it is held to be a dividend, from what fund it will be deemed to have been declared.

A division of profits by a corporation regardless of the manner in which done is a dividend as contemplated by section 2 (a) of the Revenue Act of 1916. The character of the distribution of profits at the time they are received fixes their status for income-tax purposes. The fact that such profits were not the subject of a formal declaration of dividend does not alter the case. There may be a division of profits among stockholders without the formality of declaring a dividend. Huntley *v.* Pioneer Iron Works, 181 N. Y., 73. In Spencer *v.* Lowe, 198 Fed. 961, 966, it is said:

> The stockholders may agree among themselves informally to distribute a certain sum as dividends without going through the form of a corporate action. No formal declaration is necessary, either by the stockholders or board of directors, and a distribution of profits by unanimous consent without corporate action is legal.

Were the profits paid to the taxpayer payments from earnings accrued since March 1, 1913? In the absence of any provision as to what earnings this dividend was paid out of—that is, whether paid out of surplus accumulated prior to March 1, 1913, or out of current earnings—the natural conclusion, in the absence of special facts, is that the dividend is an ordinary dividend and declared out of the more recent earnings. Congress has provided an exemption in the act as to dividends received by a taxpayer where such dividends are declared out of surplus accumulated prior to March 1, 1913, and the burden is obviously on the taxpayer to show that this particular income comes within the class of exempted income. The first question is therefore answered in the affirmative.

II AND III.

2. In such a case, what is the effect for income-tax purposes of a formal declaration by the directors of the corporation made at a considerable time after the division of profits that such profits are dividends from surplus accumulated prior to March 1, 1913, and not from current earnings?

3. In the same circumstances, what is the effect of an entry against the surplus account made at the time of such a declaration of dividend by the directors in determining the taxability of amounts received in such a division of profits?

If a corporation during the taxable year 1916 paid dividends without specifying whether they were declared from earnings accumulated before March 1, 1913, or from earnings accumulated thereafter, no reason appears why, under the terms of the Revenue Act of 1916, the corporation might not, during the taxable year, pass a resolution and adjust its accounts so as to indicate that the dividend was declared out of earnings accumulated prior to March 1, 1913. In such a case the stockholder would get the benefit of such action. The telegram dated February 19, 1917, is not approved; the taxable year had in that case passed without the passage of such resolution, and without the necessary adjustment of accounts. In the present case no resolution specifying the funds from which the dividend was declared and no adjustment of accounts occurred, as regards the taxpayer's calendar year 1916, prior to February 23, 1917. This date is outside the taxable year, and, so far as appears, the actual work of closing the corporation's accounts had previously been completed. The attempted adjustment of income comes too late to affect the status which had been established by the payment of the dividend without any statement as to the fund out of which payment was made. This conclusion is strengthened by the fact that as late as September 25, 1917, the revenue agent reported that no entries had been made on the books to carry out the provisions of the resolution.

It is therefore held that a stockholder who has received payments because of his stock ownership in a corporation, which profits were not the subject of a formal declaration of dividend at the time they were received and which were not then entered on the corporation's books against surplus accrued prior to March 1, 1913, is required to return such division of profits as dividends and pay the income tax thereon pursuant to Article 107 of Regulations 33 (Revised) and T. D. 2659.

The formal declaration of such dividend by the directors of the corporation at a date one year after the dividend had been paid and subsequent entries made on the books of the corporation do not have the effect of relieving the taxpayer of tax on such dividends.

Section 201, Article 1541: Dividends. 15-19-442.
T. B. R. 45.

Revenue Act of 1916.—Taxation of cash dividend paid by subsidiary to parent corporation.

Opinion is requested as to liability of the X Corporation to income taxation in the year 1916 under the Revenue Act of 1916 upon a cash dividend of one of its subsidiaries, the Y Company. The question arises as follows: The X Corporation was incorporated in June, 1916, to acquire the entire capital stock of the Y Company, and that of the Z Company. The X Corporation issued its shares of stock to the stockholders of the Y Company in exchange for their shares of stock. Thereupon, the Y Company distributed its surplus to its sole stockholder, the X Corporation, by way of a cash dividend. A considerable part of the cash so received by the X Corporation was used by it in connection with the issuance of its stock to acquire the stock of the Z Company.

Under the Revenue Act of 1916 cash dividends paid to corporations were taxable if paid out of earnings or profits accrued since March 1, 1913. (See Section 2(a). See also Regulations 33 (revised), paragraphs 372, 417.) The distribution of the surplus of the Y Company to the X Corporation, its stockholder, was in form a cash dividend. The latter corporation bought—or, more properly, secured by exchange—shares of stock of the former corporation, not the assets of that corporation. Consequently, the X Corporation succeeded to the rights of the stockholders of the Y Company, not to the rights of that corporation. A distribution by that corporation among such stockholders of surplus earned after March 1, 1913, would have been taxable to them as a cash dividend. It is immaterial, as was pointed out in Lynch *v.* Hornby (247 U. S., 346), that such "dividend distribution diminishes by just so much the assets of the corporation and in a theoretical sense reduces the intrinsic value of the stock." The X Corporation having succeeded to the rights of such stockholders was taxable in the same manner unless the fact that it was the sole stockholder makes a difference.

The fact that the X Corporation was a sole stockholder does not affect its liability to taxation upon this dividend distribution. Under the Revenue Act of 1916 there was no provision for consolidated returns, consequently rulings based upon a requirement of consolidated returns in cases of affiliated corporations do not apply. The X Corporation must be treated as a taxable unit distinct from the Y Company. Nor do the decisions of Southern Pacific Co. *v.* Lowe (247 U. S., 330) and Gulf Oil Corporation *v.* Lewellyn (248 U. S., 71) warrant a ruling that the dividend in question is not taxable. In each of those cases the declaration of a dividend by a subsidiary out of surplus earned by the enterprise as a whole prior to the taxable year, payment being effected by entries upon the respective companies' books, was regarded as a mere formality and not determinative of tax liability for the year of such declaration and bookkeeping entries. In the present case the transfer of actual cash constituting the surplus of the Y Company earned before it became a subsidiary to the treasury of its sole stockholder, the X Corporation, was a matter of substance and can not be disregarded.

It is to be noted that the taxability of the distribution in question does not depend upon the form adopted for transferring the surplus from the subsidiary to the parent corporation. A tax would have been imposed if any other method had been employed for transferring the surplus to the X Corporation and getting the stock of that corporation into the hands of the former stockholders of its subsidiary, the Y Company. If (*a*) the subsidiary had paid the cash to the parent corporation in exchange for its stock and distributed such stock among its stockholders, or (*b*) the subsidiary had made a cash distribution among its stockholders and such stockholders in turn had bought for cash the stock of the parent corporation the distribution by the Y Company among its stockholders would have been taxable as a dividend.

It is held, therefore, that the X Corporation was subject to income taxation in the year 1916 under the Revenue Act of 1916 upon the surplus of the Y Company distributed to it by way of a cash dividend to the extent that such surplus was earned after March 1, 1913.

Section 201, Article 1541: Dividends. 21-19-520.
(Also Section 213, Article 31.) **T. B. R. 60.**
(Also Section 233. Article 541.)
(Also Section 320, Article 801.)

REVENUE ACT OF 1916 AS AMENDED BY THE REVENUE ACT OF 1917, AND REVENUE ACT OF 1917.

Distributions to a domestic corporation, a stockholder in a foreign corporation deriving no income from sources within the United States during the year 1917, of profits or surplus accumulated by such foreign corporation prior to the year 1917, are not taxable to the domestic corporation at the rates prescribed for the year 1917, and are not subject to the excess-profits tax imposed by Title II of the Revenue Act of that year.

In the year 1917 a corporation organized in the United States owned stock in a foreign corporation which, it is represented, derived no income from sources within the United States within the year 1917, and consequently was not subject to taxation under Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917, or Title I of the Revenue Act of 1917. During the year 1917 this foreign corporation declared dividends. The domestic corporation claims that these dividends were distributed out of profits or surplus of the foreign corporation accumulated prior to the year 1917, and that under section 31, subdivision (b), of the Revenue Act of 1916, as amended, such dividends were not taxable to the domestic corporation at the rates prescribed for the year 1917 and were not subject to the excess-profits tax imposed by Title II of the Revenue Act of 1917. Is this the correct construction of said section 31, subdivision (b)?

Section 31, subdivision (b), added to the Revenue Act of 1916 by section 1211 of the Revenue Act of 1917 provides that "any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company," in the year 1917 (1) "shall be deemed to have been made from the most recently accumulated undivided profits or surplus," (2) "shall constitute a part of the annual income of the distributee for the year in which received," and (3) "shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporations." This subdivision provides however, that (4) earnings or profits accrued prior to March 1, 1913, may be distributed, exempt from the tax, after the distribution of earnings or profits accrued since March 1, 1913, and that (5) the subdivision shall not apply to any distribution made prior to August 6, 1917, out of earnings or profits accrued prior to March 1, 1913. The "rates prescribed by law" are obviously the rates prescribed for the taxation of income by the Revenue Act of 1913 and the Revenue Act of 1916 in its original form for the appropriate years, as well as those prescribed by the Revenue Act of 1916, as amended, and the Revenue Act of 1917.

The income-tax provisions of the Revenue Act of 1916 are contained in Title I thereof and are amended by Title XII of the Revenue Act of 1917, subdivision (b) of section 31 being an amendment made by said Title XII. The income-tax provisions of the Revenue Act of 1917 are contained in Title I and the excess-profits tax provisions in Title II of that act.

The basic question is whether subdivision (b) of section 31 above referred to applies to dividends of foreign corporations deriving no income from sources within the United States and, consequently, not subject to taxation under Title I of the Revenue Act of 1916, as amended, or Title I (or Title II) of the Revenue Act of 1917. The answer to this question depends upon whether the words "corporation, joint-stock company, or association, or insurance company" in that subdivision include such foreign corporations. These words are used frequently throughout Title I of the Revenue Act of 1916 in both its original and its amended form and Title I of the Revenue Act of 1917, sometimes without a limiting phrase. (See Revenue Act of 1916, secs. 1 (b), 2 (a), 8 (f), 9 (b), 10, 13 (d), 14 (a), (b), and 16, amending Revised Statutes, sec. 3173; Revenue Act of 1917, secs. 4, 1206, amending sec. 10 of Revenue Act of 1916, 1211, adding to the Revenue Act of 1916, secs. 28, 31 (a), 32; see also Revenue Act of 1916, secs. 8 (c), (d), 9 (b), and Revenue Act of 1917, sec. 1205, amending sec. 9 of Revenue Act of 1916), and sometimes limited by one of the following phrases: "organized in the United States" (see Revenue Act of 1916, secs, 10, 12 (a); Revenue Act of 1917, sec. 1206, amending sec. 10 of Revenue Act of 1916); "organized, authorized, or existing under the laws of any foreign country" (see Revenue Act of 1916, secs. 10, 12 (b); Revenue Act of 1917, sec. 1206, amending sec. 10 of Revenue Act of 1916); "resident * * * whose net income is taxable under this title" (see Revenue Act of 1916, sec. 10; Revenue Act of 1917, sec. 1206, amending sec. 10 of Revenue Act of 1916); "however created or organized" (see Revenue Act of 1916, sec. 3); "subject to this tax" and similar phrases (see Revenue Act of 1916, secs. 5 (b), 9 (b), 13 (a), (b), (c); Revenue Act of 1917, secs. 4, 1205, amending sec. 9 (b) of Revenue Act of 1916, 1206, amending sec. 10 of Revenue Act of 1916, 1210, amending sec. 26 of Revenue Act of 1916 as amended; see also sec. 206 of the Revenue Act of 1917); "domestic or other resident" (see Revenue Act of 1916, secs. 13 (e), (f); Revenue Act of 1917, sec. 1208, amending sec. 13 (e) of Revenue Act of 1916); "nonresident alien * * * not engaged in business or trade within the United States and not having any office or place of business therein" (see Revenue Act of 1916, secs. 13 (e), (f); Revenue Act of 1917, sec. 1208, amending sec. 13 (e) of Revenue Act of 1916);

"required by law to make, render, sign, or verify any return" (see Revenue Act of 1916, sec. 18; see also Revenue Act of 1917, sec. 1209 amending sec. 18 of Revenue Act of 1916). In section 13, subdivision (b), of the Revenue Act of 1916, the word "foreign" is used limiting the words "corporation, company, or association." The use of these limiting phrases indicates that there are, for purposes of the income-tax laws, corporations organized in the United States, that is, domestic corporations; corporations organized in foreign countries, that is, foreign corporations, resident corporations, and nonresident corporations. (See secs. 10 and 13 (e), (f), of the Revenue Act of 1916 in both its original and amended form, and especially sec. 13, subdivisions (e) and (f), which in terms refer to "domestic or other resident corporations" and "nonresident alien * * * corporations * * * not engaged in business or trade within the United States and not having any office or place of business therein.") The natural inference is, therefore, that when, as in subdivision (b) of section 31, the word "corporation" is used without any limiting phrase it includes all of these classes of corporations, unless some of them are excluded because clearly outside the purpose of the statutory provision in which the word appears.

Further textual analysis tends to show that the word "corporation" is used in subdivision (b) of section 31 without limitation. The Revenue Act of 1916, section 5 (b), and the Revenue Act of 1917, section 4, provide that "dividends" of a corporation "taxable upon its net income" shall be credited against income of stockholders, and thus in effect be exempt from certain taxes, implying that there may be "dividends," within the meaning of the income-tax laws, of corporations which are not taxable upon their net income; that is, that the word "dividends" is not confined to distributions made by taxable corporations. Section 31 (a), added to the Revenue Act of 1916 by section 1211 of the Revenue Act of 1917, as well as earlier provisions (see Revenue Act of 1916, sections 2 (a), 10), defines "dividends" as meaning "any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company" out of certain earnings or profits. It necessarily follows that the phrase "any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company" in section 31 (a) applies to nontaxable corporations. The same language in section 31 (b) should be given the same meaning. Practically, if not absolutely, the only class of nontaxable corporations which makes any distribution to its stockholders or members is that of foreign corporations which derive no income from sources within the United States. Hence the conclusion that such corporations are within the provisions of subdivision (b) of section 31.

Nothing in the statute warrants the inference that distributions by foreign corporations deriving no income from sources within the United States are outside the provisions of section 31, subdivision (b). Such an inference can not fairly be drawn from the fact that the provisions of section 26, added to the Revenue Act of 1916 by section 402 of the Revenue Act of March 3, 1917, and amended by section 1210 of the Revenue Act of 1917, requiring corporations to make returns of their payments of dividends and of the tax years in which they were earned, is limited in its application to corporations "subject to the tax" imposed by the Revenue Act of 1916.

Probably the equitable consideration which moved Congress to pass subdivision (b) of section 31 was the thought that the earnings of a corporation are in substance earnings of its stockholders for the year in which they are accumulated by the corporation, and that to tax such earnings at the rate for the year in which they are divided is to place too great emphasis upon the corporate fiction. This consideration applies as thoroughly to dividends of foreign corporations which derive no income from sources within the United States as to dividends of other corporations. It is true that there are some administrative difficulties in the application of this subdivision to dividends of such foreign corporations, especially in checking the allocations of dividends to the several tax years made by stockholders, since section 26 of the Revenue Act of 1916, as amended, as above stated, does not apply to such corporations. On the whole, however, it can not be said that these administrative difficulties warrant a distinction for which there is no basis in the language or apparent purpose of the statute.

Subdivision (b) of section 31 does not differentiate corporate and individual stockholders. Consequently, it follows, from the conclusion that the subdivision applies to distributions made by a foreign corporation which derives no income from sources within the United States, that a domestic corporation owning stock therein is subject to income tax upon distributions to it at the rates prescribed by law for the years in which the foreign corporation accumulated the profits or surplus. If, as claimed by the domestic corporation in the present case, the profits or surplus of the foreign corporation distributed in the year 1917 were accumulated prior to that year, the dividends received by the domestic corporations were not subject to the 4 per cent tax imposed by Title I of the Revenue Act of 1917, but were subject to the 2 per cent or 1 per cent tax imposed by the Revenue Act of 1916, and the Revenue Act of 1917, respectively, or, if accumulated prior to March 1, 1913, were not subject to income tax. So far as such distribution was made after August 6, 1917, it would, of course, be subject to the presumptions stated in the subdivision.

It remains to consider whether the rule applicable to income taxes above set forth applies to the excess-profits tax imposed by Title II of the Revenue Act of 1917. This tax is levied "upon the income of every corporation, partnership, or individual" according to certain prescribed "percentages of the net income." (Sec. 201.) Provision is made that "for the purposes of this title the net income of a corporation shall be ascertained and returned * * * for the taxable year upon the same basis and in the same manner as provided in Title I" of the Revenue Act of 1916, as amended, with a deduction of corporate dividends taxable under that act. (Sec. 206.) The excess profits tax is, therefore, a tax upon income. Nothing in the subdivision indicates that "rates prescribed by law" as used therein do not include all rates prescribed by law for the taxation of income whether in the form of excess-profits taxes or otherwise. The "rates prescribed by law" for the taxation of income of a corporation for the year 1917 include, therefore, not only the rates of income tax proper, but also the rates of excess-profits tax. What is true for the year 1917 is equally true of prior years. As there was no excess-profits tax for the years prior to 1917 under either Title II of the Revenue Act of 1917 or otherwise, the "rates prescribed by law" for the taxation of income of corporations for those years do not include any rates for excess-profits taxes. It follows that profits or surplus of a foreign corporation which derives no income from sources within the United States accumulated prior to the year 1917 distributed to a corporate stockholder in the year 1917 are not subject to excess-profits tax under Title II of the Revenue Act of 1917. As this result is the same as would be attained if the domestic and the foreign corporations were affiliated and filed a consolidated return, it can not be regarded as unreasonable. It has, moreover, the same equitable consideration back of it as does the imposition of the income tax proper at the rate for the year in which profits or surplus were accumulated, or the imposition of no such income tax if profits or surplus were accumulated prior to March 1, 1913.

It is held, therefore, that distributions to a domestic corporation, a stockholder in a foreign corporation deriving no income from sources within the United States during the year 1917, of profits or surplus accumulated by such foreign corporation prior to the year 1917 are not taxable to the domestic corporation at the rates prescribed for the year 1917, and are not subject to the excess-profits tax for that year imposed by Title II of the Revenue Act of 1917.

22-19-529.
Section 201, Article 1541: Dividends. T. B. R. 63.

Revenue Act of 1913.—Certain dividends held to be cash dividends.

The M Company is a holding corporation organized to hold stocks of various companies. It owned portions of the outstanding stock of the N, O, P, R, and S companies. The balance of the stock in these companies was independently owned by managers and employees of the branches. In 1914 these companies declared dividends payable in cash, and at the same directors' meetings authorized an increase in the capital stock equivalent in amount to the cash dividend declared. The amount received by the M Company from the five subsidiary corporations was 165x dollars. All the shareholders of all the companies had agreed to purchase the new stock issue with this dividend, and this was known to the directors when the dividend was declared. All that actually happened was an exchange of checks, and the company represents that there were not sufficient funds in its bank account to meet its checks, but that the checks received offset the checks paid out. This procedure was deliberately adopted in preference to issuing a stock dividend because of certain provisions of State statutes. The company contends that this is in substance a stock dividend and therefore not taxable, although it takes the form of a cash dividend and the purchase of stock. The dividend was taxed as a cash dividend by the Income Tax Unit.

It is admitted that this particular form was deliberately adopted and that the company desires to get the benefit of this form of procedure under the State statutes regulating the issue of securities. If it were not for the contemporaneous agreement between the stockholders to apply the dividend to the purchase of stock, it would be clear that this was a cash dividend. (Davis *v.* Jackson, 152 Mass., 58.) In Rand *v.* Hubbell (115 Mass., 461), it was held that where the vote of the directors declaring the dividend payable in cash imposed the conditions that the dividend should be used for the purchase of stock, the dividend should be considered a stock dividend. In the principal case, however, there was no corporate action making the cash dividend conditional upon subscription to the new issue. So far as can be determined the stockholder was entitled to the cash, whether he fulfilled his agreement to subscribe for the new stock or not. If there is an option on the part of the stockholders to demand the cash or subscribe for the stock, all of the cases agree that the dividend is a cash dividend. (Fletcher Cyc. Corporations, sec. 3715.) In the opinion of the Advisory Tax Board, there was such an option here, although the failure to subscribe might have given rise to an action for damages against the stockholder. The dividend is, therefore, a cash dividend, and taxable under the act of October 3, 1913. (Lynch *v.* Hornby, 247 U. S., 339.)

Section 201, Article 1541: Dividends. 20–19–502.
(Also Section 213, Article 31:) T. B. M. 77.

Effect of rescission upon illegal dividend.

The M Company, organized in 1916, began business in 1917, with a capital of 5x dollars and no surplus. At the end of 1917 the books of the company showed a profit of 52x dollars. Its merchandise inventory on that date was 93x dollars, and was based upon the cost of the specific lots then on hand. One large item in this inventory was purchased in 1917 for 43x dollars, at the rate of 7y dollars a ton, plus freight and inspection charges. This item was inventoried at cost.

In November, 1917, the War Industries Board fixed the market price of material of this character at 5y dollars a ton, plus freight and inspection charges, and this market rate prevailed on December 31, 1917.

On the basis of the profits shown by the books, the board of directors of the company in 1917 declared a dividend of all the profits for the year 1917, payable in 1918. Before July, 1918, the company paid a dividend of 43x dollars. The company states that there were no net earnings for 1918. Later in 1918, the material in question was sold for 24x dollars, which was 19x dollars less than the cost, and the figure at which it had been inventoried. Subsequently, at a stockholders' meeting held early in 1919, the board of directors was authorized to rescind the original dividend and to declare a new dividend for the amount of the actual profits. The stockholders also agreed to pay back the amount of the overpayment, and A individually did, in effect, pay back his share of the dividend. The department has ruled that stockholders of the M Company must pay income tax for 1918 upon the full dividend distributed during 1918, although such dividend was in part subsequently rescinded. A, who owned 98 per cent of the stock of the company, has appealed to the Advisory Tax Board.

A was a director of the corporation. It was the duty of the directors in December, 1917, to ascertain the surplus available for dividend distribution by reference to the actual value of the assets of the company on hand on that date. They could not assume that they would be able to sell for 7y dollars per ton, material which cost them that amount when the market price was 5y dollars a ton. The statute authorizing the directors in their discretion to declare dividends also provides that such dividends shall in no case exceed the amount of the net profits actually acquired by the company, so that the capital shall never be impaired.

And it has been held generally:

If a dividend has been illegally declared in the sense that its declaration is *ultra vires*, as where it is a dividend out of assets when there is no surplus to divide, then it seems that it may be rescinded by the corporation even after it has been paid, and the corporation may recover it of the shareholders as so much money paid to their use under mutual mistake. (10 Cyc. 549, and cases cited.)

The taxpayer has sufficiently established that the dividend declared in December, 1917, was in part illegal, and that A as director was personally liable to the company to the extent that such dividends exceeded the true earnings of the company measured by the actual value of the assets and as shareholder to the extent that such excess was payable to him. This is not a question of determining net income for the purposes of the income tax act, but a question solely as to the legality of the dividend declared in December, 1917. To the extent that the company had a legal right to force rescission and repayment of such dividend, and such rescission and repayment were actually made, the rescinded dividend should not be considered income for the purposes of taxation, and it is recommended that the income taxes of the individual stockholders for 1918 be assessed on that basis.

Section 201, Article 1541: Dividends.

(See 2–19–140; sec. 213(a), art. 52.) Dividends paid in one year but not actually received by stockholders until the succeeding year.

Section 201, Article 1541: Dividends.

(See 12–19–398; sec. 213(a), art. 31.) Effect on stockholder's gross income of dividends legally declared and paid in 1918 and subsequently after the passage of the Revenue Act of 1918, repaid to the corporation in 1919, pursuant to action by the corporation purporting to rescind the declaration of the dividend.

Section 201, Article 1542: Presumption as to source of distribution. 12–19–395. T. B. R. 43.

A corporation making returns on the calendar year basis had a surplus earned prior to 1913, but none earned after that date and prior to January 1, 1918. It paid dividends during the first 60 days of 1918. The earnings for the period immediately preceding the payment of each of these dividends were sufficient to cover the amount of the dividends. Shall such dividends be treated as paid out of the earnings of the calendar year 1918 or out of surplus earned prior to March 1, 1913?

Section 201, paragraph (b), of the Revenue Act of 1918 provides, in part, with respect to corporations other than personal service corporations that "Any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913 * * *." Paragraph (e) provides, in part, that "Any distribution made during the first 60 days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years * * *." The question is therefore as to which presumption is controlling in the instant case.

Paragraph (b) lays down the fundamental principle that earnings or profits accumulated since February 28, 1913, and distributed among stockholders are taxable to them, while earnings or profits accumulated prior to March 1, 1913, and so distributed, are not taxable. No further provisions for allocation of cash distributions to earnings or profits are made with respect to the tax liability of stockholders of corporations other than personal service corporations but further and more detailed provisions are made for allocation of distributions with respect to invested capital and with respect to stock dividends and dividends of personal service corporations. (See section 201, paragraphs (a), (b), (d), and (e). It is, however, the opinion of the Advisory Tax Board that these more detailed provisions are subordinate to the fundamental rule expressed in paragraph (b). These provisions deal with rate and method of taxation rather than with liability and should not be extended so as to relieve from taxation income which would be subject to taxation under the more fundamental rule. In accordance with this principle paragraph (e) should yield to paragraph (b).

Support for the conclusion that paragraph (e) does not have the effect of relieving dividends from taxation is found in the use of the word "taxable" in the phrase "preceding taxable years." Article 1542 of Regulations 45 indicates that the presumptions stated in section 201 are to be applied only "so far as possible." Accordingly, the part of paragraph (e) above quoted is to be construed as if it read as follows:

> Any distribution made during the first 60 days of any taxable year shall be deemed to have been made from earnings or profits, *if any*, accumulated during the preceding taxable years, *otherwise from earnings or profits, if any, accumulated during the taxable year.*

While it is evident that the words "preceding taxable years" do not refer to statutory taxable years (sec. 200)—else there would be no "preceding taxable years" before the taxable year 1918—they should be construed to apply only to years the accumulated earnings or profits of which are taxable, that is, years subsequent to March 1, 1913. If the statute is so construed a distribution made during the first 60 days of the taxable year 1918 will be deemed to have been made from earnings or profits accumulated during that year if no earnings or profits had accumulated after February 28, 1913, and prior to January 1, 1918.

It is held, therefore, that if a corporation had earnings or profits accumulated prior to March 1, 1913, but none accumulated after that date and prior to January 1, 1918, and paid dividends during the first 60 days of 1918, earnings or profits sufficient therefor having accumulated after December 31, 1917, such dividends should be treated as paid out of the earnings or profits accumulated after December 31, 1917.

Section 201, Article 1542: Presumption as to source of distribution. 1–19–8. O. D. 4.

In applying subdivision (e) of section 201, Revenue Act of 1918, to any case, the "first sixty days of any taxable year" includes March 1, except during leap years.

Section 201, Article 1542: Presumption as to source of distribution. 1–19–9. O. D. 5.

The 60-day provision of section 201 (e) of the Revenue Act of 1918 is not for the purpose of determining the rates of tax to be paid by the shareholders, but is for the purpose of allowing the corporation to determine the earnings from which the dividend is paid.

Section 201, Article 1542: Presumption as to source of distribution. 6–19–266. O. D. 163.

A dividend will be deemed to have been paid out of current earnings to the extent possible, and taxable to the recipient accordingly, notwithstanding that there is an actual impairment of capital and the books show an apparent surplus based on an arbitrary valuation of good will, trade-marks, etc.

Section 201, Article 1542: Presumption as to source of distribution.

(See 23–19–552, sec. 325, art. 813.) Repayment to principal stockholder of paid-in surplus.

Section 201, Article 1544: Dividends paid in property. 5–19–243. O. D. 152.

Where a national bank utilized a portion of its undivided profits in the creation of a savings bank and trust company, the stock of said savings bank and trust company being issued in the names of trustees for all shareholders of the national bank, and the certificates of stock of the national bank showing on the face thereof that the holders are entitled to their pro rata share of the capital stock of the savings bank and trust company, the stockholders would be deemed to have received a dividend in specie and would be liable for tax on the value of certificates of stock in the new corporation received by them.

Section 201, Article 1544: Dividends paid in property. 17–19–469.
(Also Section 234, Article 561:) O. D. 262.

When dividends are paid in Liberty bonds having a market value below par the difference between par and market is not an allowable deduction for income tax purposes.

Section 201, Article 1545: Stock Dividends. 11–19–368. S. 1081.

Ruling under Revenue Act of 1916.

Stock dividend declared from a surplus created by the capitalization of good will.—Where a stockholder claims he is not subject to income tax upon a stock dividend received in 1916, on the ground that such dividend was declared from a surplus created by the capitalization of the good will of the corporation, and the claim is not supported by contemporaneous records of the corporation, showing that such dividend was declared from such surplus and by proofs that the accounts of the corporation are in accordance with such records, the claim can not be allowed. It is indispensable in any such case that the proof shall disclose from the time of the creation of the surplus by the capitalization of good will continuously the item of capitalized good will against which stock dividends are sought to be declared. In any case where the surplus account does not show such item of good will, but commingles the capitalized good will with undivided profits and earned surplus, it is clear that stock dividends declared out of such surplus account are not exempt from taxation. (Provisions of Revenue Act of 1917 are not here considered.)

Section 201 (c) (d) (e), Article 1545: Stock dividends. 1–19–7.
(Also Section 326, Article 859:) T. B. R. 3.

Under the Revenue Act of 1917 stock dividends paid during any taxable year, and under the Revenue Act of 1918 stock dividends paid after the first 60 days of any taxable year, shall be deemed to have been paid from earnings or profits, but the payment of a stock dividend has no effect upon the amount of invested capital.

In determining the amount by which invested capital should be reduced on account of dividend payments made during the taxable year in excess of current earnings, should stock dividends be treated the same as cash dividends?

The following example illustrates the point in question:

Current earnings to Apr. 1, 1917	$33,000
Stock dividends, Apr. 1, 1917	30,000
Balance current earnings undistributed	3,000
Earnings for April, 1917	12,000
Current earnings on hand May 1, 1917	15,000
Cash dividend May 1, 1917	27,000
Dividend payments in excess of current earnings	12,000
12,000 averaged for eight months	8,000

which is the amount by which invested capital as of the beginning of the year should be reduced.

The provisions of section 31 (a) of the Revenue Act of 1917, and section 201 of the Revenue Act of 1918, place stock dividends upon the same basis as cash dividends in this connection. The latter section provides, "That the term 'dividend' * * * means any distribution made by a corporation * * * whether in cash or in other property or in stock of the corporation out of its earnings or profits accumulated since February 28, 1913," and the definition in the Act of 1917 is substantially the same. Section 31 (b) of the Act of 1917 provides that any distribution made during the year shall be deemed to have been made from the most recently accumulated undivided profits or surplus. Section 201 (e) of the Act of 1918 provides that any distribution made after the first 60 days of any taxable year shall be deemed to have been made from current earnings or profits so far as possible. The language of these provisions is general and is susceptible of only one interpretation. It applies to all distributions of earnings, whether made in cash or in other property or in stock of the corporation. And any such distributions in excess of earnings or profits of the taxable year will reduce the surplus at the beginning of the taxable year by the amount of such excess.

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The payment of a stock dividend, however, has no effect upon the amount of invested capital, article 859, Regulations 45 (final edition). The distribution of a stock dividend is in effect a capitalization of current earnings or of earned surplus on hand at the beginning of the year. The capitalization of current earnings does not increase the invested capital, and the capitalization of surplus on hand at the beginning of the year does not decrease the invested capital. Nevertheless a stock dividend distributed at any time during the year under the Act of 1918 or after the first 60 days of the taxable year under the Act of 1918 must be deemed to have been paid from current earnings or profits so far as possible, so that the accumulated earnings or profits of the taxable year available thereafter for cash dividends or other payments are correspondingly reduced. In the specific illustration given, therefore, the result is correct, but in a case in which the stock dividend was in whole or in part a capitalization of the surplus on hand at the beginning of the taxable year, no reduction in invested capital should be made because of the capitalization of such surplus.

Section 201, Article 1547: Sale of stock received as dividend. 30–19–634. A. R. R. 6.
(Also Section 202, Article 1561:)

Treasury Decision 2734 is in accordance with the holding of the Supreme Court in the Towne *v.* Eisner case, and lays down a correct method for determining the profit on stock held on March 1, 1913, on which a stock dividend has subsequently been received.

A has appealed to the Committee on Appeals and Review from the holding of the Income Tax Unit to the effect that he is liable for tax on profits on the sale of certain stock under the following circumstances:

The M Company is a corporation having an original capitalization of 2x dollars, the market value of which on March 1, 1913, was 20y dollars per share. In 1915 a stock dividend of 3x dollars, or 150 per cent, was paid out of surplus and undivided profits. During 1917 the taxpayer sold shares of stock in the M Company at 20y dollars per share, but did not return the profit as taxable income. As each 20y dollars of value on March 1, 1913, was represented at the time of sale, owing to the 150 per cent dividend, by 2½ shares, the Income Tax Unit finds that the value of the stock sold as of March 1, 1913, was 8y dollars per share and that the difference, or 12y dollars per share, represented taxable income.

The committee is of the opinion that the Income Tax Unit is clearly correct in this contention.

The Supreme Court, in the Towne *v.* Eisner case, after quoting as follows from Gibbons *v.* Mahon (136 U. S., 549, 559, 560), "The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones," went on to say, in direct connection with the case under consideration, "It is alleged and admitted that he receives no more in the way of dividends and that his *old and new certificates together are worth only what the old ones were worth* before. * * * What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new." To hold that the appellant's original certificates retained their original value of 20y dollars per share and that the shares received as a stock dividend had a value of only par, as would be necessary to sustain his contention, is to negative the whole reasoning of the court in the above decision.

Section 201, Article 1548: Distribution in liquidation.

(See 2–19–141, sec. 213(a), art. 52.) Distribution in liquidation extending over two years for which tax rates differ.

Section 201, Article 1548: Distribution in liquidation.

(See 30–19–635, sec. 213(a), art. 52.) Liquidation distributions made in installments.

Section 202.—BASIS FOR DETERMINING GAIN OR LOSS.

Section 202 (a), Article 1561: Basis for determining gain or loss from sale. 17–19–470. O. 880.

For the purpose of determining gain or loss resulting from the sale of a homestead upon which entry had been made prior to March 1, 1913, and patent acquired subsequent to that date, the entryman will be regarded as having acquired the property prior to March 1, 1913, and the fair market price or value of the property of that date shall be taken as the basis.

Section 202 (a) of the revenue act of 1918 provides:

That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date the cost thereof; * * *.

The question is raised, in connection with the theory that unless a homesteader, or the patentee of other lands, made his final proof on or before the 1st day of March, 1913, he should be credited only with the net cost of the improvements that he has placed upon his lands, and that this net value is the deductible sum to be taken from the selling price, in case he has sold his land during the taxable income year.

While it is true that the legal title to property acquired under the homestead laws does not pass until Government patent is issued (U. S. Rev. Stats., secs. 2288 to 2309; Oregon, etc., *v.* Quigley, 80 Pac., 401), nevertheless, the entryman from the date of his entry holds a "substantial inceptive title." (Knapp *v.* Alexander, 237 U. S., 162; U. S. *v.* Buchanan, 232 U. S., 452.) If a trespass is committed upon the land prior to final proof, the entryman may recover damages as would the holder of the fee, and practically no allowance is made for the actual state of the title. (Spokane Falls, &c., Railway *v.* Zeigler, 165 U. S., 65; Red River & Lake of the Woods R. Co. *v.* Sture, 20 N. W., 229; Atchison, T. & S. F. R. Co. *v.* Richter, 148 Pac., 482 (N. Mex., 1915); Flint, etc., Co. *v.* Gordon, 41 Mich., 420.)

Until a "receiver's final certificate" is issued, the homesteader is expressly prohibited from alienating the property. Nor can he mortgage the same. (See Thompson on Homestead Laws.) But the issue of such final certificate conveys the equitable title (U. S. *v.* Detroit Timber Co., 131 Fed., 668); and after that time he can sell or mortgage his interest. (S. S. Dale & Sons *v.* Griffith, 45 South., 543; Laughlin *v.* Fariss, 50 Pac., 254; Peterson *v.* Sloss, 81 Pac., 744; Kent Lumber Co. *v.* Clarke, 140 Pac., 556; Peyton *v.* Desmond, 129 Fed., 1.) At that time also the land becomes taxable (Cannon *v.* Hood River, etc., 154 Pac., 397) and liable for debts of the homesteader. (Ruddy *v.* Rossi, 154 Pac., 977.) Thereafter the Government holds the title in trust. (U. S. *v.* Steenerson, 50 Fed., 504.)

Where several proceedings are essential to complete a particular transaction, such as a conveyance or deed, the last proceeding which consummates the conveyance is held for certain purposes to take effect by relation as of the day when the first proceeding was had. (Gibson *v.* Chouteau, 13 Wal., 92.) This fiction has been generally resorted to by courts whenever the cause of justice is promoted thereby. (Knapp *v.* Alexander, 237 U. S., 162, 167. It was approved by Judge Cooley in Flint, etc., Railway Co. *v.* Gordon (41 Mich., 420) in the following language:

> If he perfected it, he was entitled to a patent which related back to the time when his entry was made and took date with it.

It is therefore held that for the purpose of determining gain or loss resulting from the sale of a homestead upon which entry had been made prior to March 1, 1913, and patent acquired subsequent to that date, the entryman will be regarded as having acquired the property prior to March 1, 1913, and the fair market price or value of the property of that date shall be taken as the basis.

No opinion is expressed as to the rule which applies in the case of persons acquiring Government lands in any other way than under the homestead laws. For decision of such cases it will be necessary to examine the statute under which the land is acquired.

Section 202(a), Article 1561: Basis for determining gain or loss from sale. 1–19–10. S. 927.
(Also Section 203, Article 1582:)

BASIS FOR COMPUTING GAIN DERIVED FROM SALES OF PROPERTY DURING TAXABLE YEAR.

> Where a taxpayer manufactures property and keeps it on hand for a number of years, until it is sold in the taxable year 1918, the gain derived is the difference between the selling price and the cost, if acquired after February 28, 1913, or if acquired prior to March 1, 1913, the fair market value as of that date; or the difference between the selling price and the inventory value of the goods at the beginning of the taxable year, on the inventory basis regularly followed by the taxpayer; that is, either an inventory basis of cost or an inventory basis of cost or market value, whichever is lower. It is not permissible to use market value except when it becomes material in taking inventory on the basis of cost or market value whichever is lower.

Advice is asked as to whether a taxpayer has a legal right under section 202(a) of the Revenue Act of 1918 to take as the basis of determining gain or loss on goods sold during the year their inventory value based upon the market value of the goods as of the beginning of the year 1918 instead of their cost at the time acquired (or 1913 value), which was used as the basis of their inventory value in former years.

Section 213 of the Revenue Act of 1918 provides that the term "gross income"—

Includes gains, profits, and income derived from salaries, wages, * * * or gains or profits and income * * * derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer * * *.

Section 202(a) provides that for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of such date, and (2) in the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory value is made in accordance with section 203.

Section 203 provides—

That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of the taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Article 1582 of Regulations 45 is the ruling of the Department pursuant to section 203.

Inventories shall be valued at (a) cost or (b) cost or market, whichever is lower.

It is stated that the X Co. has for many years been engaged in the business of manufacturing and selling merchandise. This company has always carried its unsold manufactured products on its books at cost. Practically all the merchandise manufactured in previous years and still on hand on January 1, 1917, was sold during the calendar years 1917 and 1918. During these two years its market price greatly increased in value because of (a) increased costs, (b) war-time prohibition of its manufacture, and (c) the approach of general prohibition. Thus, merchandise manufactured in 1913, 1914, 1915, and 1916, although carried on the company's books at cost, was worth considerably more at market price on January 1, 1917, had reached a still higher valuation on January 1, 1918, and was sold during 1918 for a still higher figure. The result of the ownership of the merchandise throughout the entire period of six years from 1913 to 1918, inclusive, was that the company received on the sales made in 1918 a profit which was the result of a gradual increase in value covering the whole period.

The position of the taxpayer is that the profit should be spread over the time of such gradual increase in value, the increment occurring in any year to be taxed at the rates applicable to that year. This contention has frequently been made in the case of property owned before March 1, 1913, and after gradual increase in value, sold at a profit in a later year. But it is definitely set at rest in that connection by section 202 (a) of the Revenue Act of 1918, quoted above, which follows similar provisions in earlier acts, and compares the selling price with cost or value on March 1, 1913, not with value after the beginning of the taxable year.

Gains and profits constituting income are to be returned as income for the taxable year in which received. (Sec. 213.) At no place in the law does it appear that the basis for determining the gain derived from the sale of property is to be the inventory value based upon the market price or value at the beginning of the taxable year in which the property is sold. It is only in the case of property acquired after March 1, 1913, that the taxpayer has the alternative of using cost or market price, whichever is lower, for the purpose of determining the gain derived or the loss sustained from the sale of the property. In other words, the rule is that the gain to be returned as income for the year in which derived from the sale of the property is to be measured by the difference between the fair market value on March 1, 1913, or if acquired thereafter, then the cost thereof, or the inventory value, i. e., either on the basis of cost or on the basis of cost or market, whichever is lower, and the price received at the sale of the property. A taxpayer, therefore, has no legal right to adopt any other basis for rendering a return of income derived from sales during the year 1918 than that provided by the law and regulations.

Mere increase in the value of property is not income to the owner for the year in which such increase is said to have occurred.

(See the following cases, where this rule was applied: Baldwin Locomotive Works *v.* McCoach, 221 Fed. 59; Industrial Trust Co. *v.* Walsh, 222 Fed. 437; and Lynch *v.* Turrish, 247 U. S. 221, and the cases referred to therein.) The advance in the value of the merchandise during the years 1913 to 1916, inclusive, could not be taxed as income under the laws then in force, since such advance did not represent income within the meaning of those laws.

It is also argued in the brief that under section 202 (a) the Commissioner is expressly required to recognize inventories at market price and that the regulations exceed the power of the Treasury Department in seeking to limit inventories to those on the basis of cost and those on the basis of cost or market, whichever is lower. This argument is based on the theory that the draftsmen of the law had two bases in mind—that is, a cost basis and an inventory basis—that a market-price basis is the only alternative possible to the cost basis, and, therefore, that "inventory value" must be market value. As a matter of fact, however, a Treasury Decision had already established two permissible bases of inventory; that is, the inventory on the basis of cost and that on the basis of cost or market value, whichever is lower. It would, therefore, be unreasonable to suppose that Congress, in giving to the Commissioner the power, with the approval of the Secretary, to prescribe a basis for inventory, meant to limit him to a different alternative than the one he had already established. If Congress intended, as the argument assumes, that the Commissioner be given no discretion, except to allow inventories at cost and at market value, it would hardly have given him discretion as to the basis to be used.

It is, therefore, held that where a taxpayer manufactures property and keeps it on hand for a number of years until it is sold in the taxable year 1918, the gain derived is the difference between the selling price and the cost, if acquired after February 28, 1913, or if acquired prior to March 1, 1913, the fair market value as of that date or the difference between the selling price and the inventory value of the goods at the beginning of the taxable year, on the inventory basis regularly followed by the taxpayer; that is, either an inventory basis of cost or an inventory basis of cost or market value, whichever is lower. It is not permissible to use market value, except when it becomes material in taking inventory on the basis of cost or market value, whichever is lower.

Section 202, Article 1561. 5–19–245.
(Also Section 203, Article 1582.) S–1003.

BASIS FOR COMPUTING GAIN DERIVED FROM SALES OF PROPERTY DURING TAXABLE YEAR; INVENTORY VALUES.

> Where a taxpayer takes inventories on the basis of cost or market price, whichever is lower, goods which were acquired before March 1, 1913, will be inventoried at the market value on March 1, 1913, or at the market price at the time of the inventory, whichever is lower. Solicitor's Memorandum 927 explained.

A question has been asked as to the following sentence occurring in Solicitor's Memorandum 927:

> It is only in the case of property acquired after March 1, 1913, that the taxpayer has the alternative of using cost or market price, whichever is lower, for the purpose of determining the gain derived or the loss sustained from the sale of the property.

The inquiry is whether this sentence is to be construed as meaning that a taxpayer who takes inventories on the basis of cost or market price, whichever is lower, is precluded from exercising this option as to goods acquired before March 1, 1913.

The word "cost" in the foregoing sentence was intended in the sense of actual cost, as distinguished from market price of the goods on March 1, 1913. The opinion was not intended to cast any doubt on the proposition that the fair market value of goods which were owned by the taxpayer on March 1, 1913, is to be used in place of the actual cost in any calculation of profits, or in any taking of inventory. Where a taxpayer takes inventories on the basis of cost or market price, whichever is lower, goods which were acquired before March 1, 1913, will be inventoried at the market value on March 1, 1913, or at the market price at the time of the inventory, whichever is lower.

Section 202, Article 1561: Basis for determining gain or loss from sale. 19–19–493.
T. B. M. 73.

> *Revenue Act of 1913.*—The excess of the proceeds of a sale in the year 1915 of stock acquired by the taxpayer prior to March 1, 1913, over the market value of such stock on March 1, 1913, determined according to the "best evidence obtainable," is income of such taxpayer for the year 1915, regardless of the fact that the sale price of such stock was less than the cost of such stock to the taxpayer.

The question under the Revenue Act of 1913 arises as follows: In the year 1900 the taxpayer purchased ——— shares of corporate stock at $100 a share, an aggregate amount of 52x dollars, and in the year 1915 sold the same shares for 36x dollars, 16x dollars less than cost, without taking into consideration interest and carrying charges. On March 1, 1913, this stock was quoted on the market at $45 a share, at which price the entire block of stock would have been worth 24x dollars, 12x dollars less than the amount realized upon the sale of the stock in 1915. The taxpayer claims that he is entitled to a deduction for loss upon the sale of the stock to the extent of the pro rata part of the reduction from cost to sale price attributable to the period after March 1, 1913. The Income Tax Unit ruled that he was not entitled to such deduction, but that on the contrary the excess of the sale price over the market value of the stock on March 1, 1913, should be included in his gross income for the taxable year 1915. From this ruling the taxpayer appeals.

Under the Revenue Act of 1913 gain derived from the sale of corporate stock is included in gross income and loss, under certain conditions, is deductible therefrom in determining net income. The rule for determining gain or loss, deduced from the most recent decisions of the Supreme Court, is stated in Treasury Decision 2740. It is there said with respect to the Revenue Acts of 1909, 1913, and 1916 that—

> In order to determine whether there has been gain or loss on a sale, and the amount of the gain, if any, in general under all three acts, an amount must be withdrawn from the gross proceeds sufficient to restore the cost of the property or the capital value that existed at the commencement of the period under consideration (either Jan. 1, 1909, or Mar. 1, 1913). * * * In apportioning the profits derived from a disposition of property acquired before and sold after January 1, 1909, for the purpose of the act of 1909, or acquired before and sold after March 1, 1913, for the purpose of the act of 1913, the division may be pro rata according to the time elapsed or may be based on an appraisal or inventory taken as of December 31, 1908, or February 28, 1913. This is a matter of detail, to be settled according to the best evidence obtainable and in accordance with valid departmental regulations.

This Treasury Decision is a summary and interpretation of the law as laid down in court decisions rather than an administrative regulation. Consequently, it may and, as it purports to, does apply to cases arising prior to its date, June 24, 1918.

The principle underlying the Treasury Decision above referred to and the cases upon which it is based is that the gain or loss resulting from a sale of corporate stock is the difference between its value on March 1, 1913 (or, more accurately, Feb. 28, 1913), and the proceeds of the sale, and is not the pro rata part of the difference between the cost of the stock prior to March 1, 1913, and the proceeds of the sale attributable to the period after February 28, 1913. Prorating is merely a method of determining value as of March 1, 1913, and is to be resorted to only when there is no better method of determining such value. When there is a better method it must be used. Market quotations of stock regularly bought and sold on the market are ordinarily the "best evidence obtainable" of its value. Any regulation which purports to make value found by the prorating method conclusive as against other evidence which is clearly better must be regarded as overruled by Treasury Decision 2740 which prescribes that value shall be determined "according to the best evidence obtainable and in accordance with valid departmental regulations." (See also Regulations 33 (revised), art. 4, pars. 60, 63). It was not intended by this Treasury Decision that regulations which exclude from consideration the "best evidence obtainable" shall be followed and, indeed, regulations which have that effect can not be regarded as valid. The case of Hays *v.* Gauley Mountain Coal Co. (247 U. S., 189) is not *contra.* In it the court approved the use of the prorating method where there was no other evidence of value at the commencement of the period.

There is nothing in the present case to indicate, and no claim is made, that the value on March 1, 1913, of the corporate stock in question was not fairly shown by the market quotations on that date. It follows that the taxpayer is entitled to no deduction for loss upon the sale of his stock but that, on the contrary, the sum of $12x$ dollars, the excess of the proceeds of the sale of stock in question in the year 1915 over the market value thereof on March 1, 1913, established by market quotations on that date, should be included in his gross income for the taxable year 1915.

The rulings of the Income Tax Unit are, therefore, affirmed, it being held (1) that under the Revenue Act of 1913 the excess of the proceeds of a sale in the year 1915 of stock acquired by the taxpayer prior to March 1, 1913, over the market value of such stock on March 1, 1913, determined according to the "best evidence obtainable," is income of such taxpayer for the year 1915, regardless of the fact that the sale price of such stock was less than the cost of such stock to the taxpayer.

Section 202, Article 1561: Basis for determining gain or loss from sale. 1–19–11. O. D. 6.

In the case of an estate which, on March 1, 1913, owned a claim against some individual or business or governmental organization, the difference between the amount received in payment of the claim and the actual value of the claim March 1, 1913, is either gain or loss, as the case may be, to be reported in the return for the year in which the claim was settled. Interest accrued on the claim from March 1, 1913, to date of settlement is taxable income to the estate. If payment was received in securities which can be proved to have been worth less than face value, the amount to be reported as taxable income is reduced accordingly. If the securities are sold, taxable income will be realized or a deductible loss sustained to the extent of the difference between the amount received from the sale and the actual value of the securities at the time acquired.

Section 202, Article 1561: Basis for determining gain or loss from sale. 1–19–12. O. D. 7.

In general, value as at March 1, 1913, of property, real, personal, or mixed, may be established by consideration of bona fide transactions in like property occurring on or about March 1, 1913, together with all other facts pertaining to such value.

Section 202, Article 1561: Basis for determining gain or loss from sale.

(See 24–19–558; sec. 212, art. 23.) Gain or loss in connection with short sales of stock.

Section 202, Article 1561: Basis for determining gain or loss from sale.

(See 30–19–634; sec. 201, art. 1547.) Determination of gain or loss on sale of stocks received as a dividend.

Section 202, Article 1562: Sale of property acquired by gift or bequest. **30–19–637.** **A. R. M. 7.**

The appraised value of stock as at the time of the creation of a trust estate, by appraisers of a State court, creates a presumption only that the stock is of the appraised value; this presumption may be rebutted by competent evidence to the effect that the stock was of another value than that appraised.

The stock acquired by this estate consisted of y shares, par value x dollars each, of the capital stock of the M company. These shares were appraised in 1916 by two appraisers appointed by the probate court, at the par value, x dollars a share. In 1918, acting under the authority granted them by the terms of the trust, the trustees sold the stock for 125x dollars. The question is whether or not any taxable income arose as a result of this sale.

Article 1562 of Regulations 45 states that the basis for computing gain or loss on a sale of this kind is the fair market price or value of the property as at the date of acquisition or as of March 1, 1913, if acquired prior thereto. The article then states that for the purpose of determining profit or loss from the sale of property acquired by bequest, devise, or descent since February 28, 1913, the value appraised for the purpose of the Federal estate tax, or in case of estates not subject to that tax, its value as appraised in the State court for purposes of State inheritance taxes, should be *deemed* to be its fair market value when acquired.

The word "deemed" is the past participle of "deem," which is defined by the Standard Dictionary as follows:

"Deem, 1. To hold in belief, estimation, or opinion; decide as a conclusion; consider; regard; believe. 2. To judge; adjudge; decide; sentence; condemn; doom. 3. To expect. 11. i. 1. To have or to be of an opinion; think; judge. 2. To pass judgment; decide."

The committee is of the opinion that this regulation does not require that the value as appraised shall be final or conclusive, but merely a presumptive value, which may be rebutted by competent evidence. Such evidence in rebuttal has been presented by this taxpayer and the question to be determined is whether this evidence does or does not rebut the presumption that the appraised value is to be accepted for income taxation purposes.

The trustees offer as evidence affidavits of individuals and balance sheets of the M Company as at January 1, 1916, and January 1, 1917. These show the following facts:

(*a*) That in addition to the par of x dollars paid in stock, assessments were made on the stockholders during various years up to and including December, 1915, in the amount of $\frac{1}{7}$x dollars.

(*b*) In a report to the State as to the condition of this company on the 31st day of December, 1917, the actual value of real estate, as near as may be estimated, is stated as 4,000x dollars. This exceeds the total assets shown by the balance sheets mentioned, in each year, by approximately 2,000x dollars, despite the fact that these assets include other values than real estate. Such changes as are given on the balance sheets between the two years in no wise would account for this excess of value from the standpoint exclusively of added properties, nor is it reasonable to assume the entire amount of appreciation represented by this estimate occurred between the two dates.

(*c*) Sales of stock were made in 1910 at 3x dollars per share, and in 1914 at 1½x dollars per share. It is expressly stated by C that his reason for selling this stock was the need for money in his business, from which it would appear that these values were conservative.

(*d*) An examination of the balance sheets submitted, in conjunction with the income tax return for the year 1917, indicates that the book value of this stock had not increased between these dates. In fact the company showed a net loss of 16*x* dollars for the calendar year 1917, which would indicate that the book value had decreased between the two dates instead of increased.

These facts tend to show that the value of the stock was greater as at the time of the creation of this estate than the appraised value of par. Furthermore, on the basis of book values, there was a decrease rather than an increase in value during the time it was held by the estate. This presumption of a decrease is offset, it is true, by the fact that the lands have been appreciating from year to year in value, which appreciation has not been taken into the accounts. Inasmuch as the evidence tends to show that the stock was worth at least 125x dollars at the time of the creation of the estate, and since this was the value at which sold, it is not believed that any profit was realized by the trustees, representative of appreciation or other increases in value, upon sale.

Section 202, Article 1562: Sale of property acquired by gift or bequest.

(See 3–19–198, sec. 219, art. 341.) Amount taxable in case securities held in trust for a beneficiary are sold.

Section 202, Article 1564: Determination of gain or loss from exchange of property. 6–19–267. T. B. R. 25.

Under a financial reorganization of a corporation a holder of bonds of such corporation who exchanges them for capital stock of the corporation of no greater par value does not realize either gain or loss. The X Co., under a reorganization plan, was required to surrender certain bonds of the Y Co. and Z Co., held by it, and to accept in exchange therefor capital stock of the Z Co. In such a case Section 202(*b*), of the Revenue Act of 1918, provides as follows:

* * * when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

In the present case certain bonds of the Z Co. and certain bonds of one of its subsidiary companies were, under a plan of reorganization, exchanged for capital stock of the Z Co., having a par value equal to the par value of the bonds exchanged, and under the section of the act above quoted it is held that the only requirement laid down by the statute is that the new securities shall have no greater face value than the old. The actual value of the respective securities is immaterial, as is also the fact that the old securities were in the form of bonds while the new securities were in the form of stock.

It is therefore held that no gain was realized nor loss sustained by the X Co. from the exchange.

Section 202, Article 1564: Determination of gain or loss from exchange of property. 19–19–494. T. B. R. 57.

Revenue Act of 1918—Sec. 202 (b).—Meaning of "fair market value" of property received in exchange for other property.

Section 202 (b) of the Revenue Act of 1918, provides: "When property is exchanged for other property the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its *fair market value, if any;* * * *."

By the use of the language quoted Congress recognized that for the puropose of determining gain or loss derived from the exchange of property for property, property received in exchange may not have any "fair market value," the object of the present inquiry is to secure a statement in general terms of the circumstances under which, for this purpose, property received in exchange may be said to have no "fair market value."

In the absence of reason to the contrary the words, "fair market value" must be given their ordinary meaning. The expression "market value," either with or without the adjective "fair," is a familiar one and has frequently been defined and explained. Without attempting in this recommendation to collate these definitions, it may be said that they amount in substance to this, that the "market value" of property is the fair value of the property in money as between one who wishes to purchase and one who wishes to sell. It is not, however, what can be obtained for the property when the owner is under peculiar compulsion to sell or the purchaser to buy; nor is it a purely speculative value which an owner could not reasonably expect to obtain for the property although he might possibly be fortunate enough to do so. "Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price. The adjective "fair" emphasizes the idea of fairness inherent in this conception of market value, and excludes any possibility of a construction of the words "market value" with reference to a market in which, or to circumstances of sale under which, for any reason a fair price could not be obtained. Under this interpretation property received in exchange for other property has no "fair market value" for the purpose of determining gain or loss resulting from such exchange when, owing to the condition of the market, there can be no reasonable expectation that the owner of the property, though wishing to sell, and any person wishing to buy will agree upon a price at which to trade unless one or the other is under some peculiar compulsion; that is, property has no "fair market value" when market conditions are such that there would be no trading in the property in question at a fair price. It does not follow, however, that property has no "fair market value" merely because there is no price therefor established by public sales or sales in the way of ordinary business. The fact that there is no "market price" or "current price" so established does not indicate that the property may not readily be sold at a fair price, and the meaning of "market value" is not ordinarily so restricted. The courts have recognized, not only that there are cases in which property has no "market value," or more properly "market price," in this restricted sense, but also that there are cases in which property has no "market value" in the broader sense in which the words are used in the statute as herein construed. See Wall *v.* Platt (169 Mass., 398); Montgomery County *v.* Schuylkill Bridge Co. (110 Pa. St., 54).

A construction of the statute in which the words "fair market value" are defined as above indicated is in accord with its theory and purpose. A fundamental consideration in income taxation is to determine when income, or elements essential to the computation of income, such as gain and loss, are realized. Clearly, gain or loss is realized upon the sale of property for cash. It seems, moreover, that even apart from express statutory provision gain or loss is realized from the exchange of property for other property which may fairly be said to be the equivalent of cash. See California Copper Syndicate *v.* Harris (41 Scot. L. R., 691; 5 Tax Cas. 159). Such was the ruling of the Bureau under the Revenue Acts of 1913 and 1916 (see Law Opinion, 434), and the Revenue Act of 1918 expressly recognizes this principle in the language now under consideration in providing that "the property received in exchange shall * * * be treated as the equivalent of cash." It is reasonable to regard property which has a "fair market value," as the words are herein defined, as "the equivalent of cash." A taxpayer receiving such property can determine the amount of his gain or loss in terms of cash with a reasonable degree of certainty and can, if necessary, without undue sacrifice obtain by the sale of such property cash with which to pay his taxes. It is, however, unreasonable to regard property which has no "fair market value," in this sense, as "the equivalent of cash." A taxpayer receiving such property can neither determine the amount of his gain or loss with certainty nor obtain cash by sale of the property without sacrifice.

It may be argued against the construction here given to the words "fair market value" that these words are used in other parts of the statute in such a way as to imply that property always has a "fair market value" and that the same meaning should be given to the words throughout the statute. Thus, in ascertaining gain or loss upon the sale or other disposition of property acquired before March 1, 1913, the basis is "the fair market price or value of such property as of that date" (sec. 202(a(1)), or, where stock or securities acquired before March 1, 1913, are exchanged for other stock or securities in connection with a reorganization, merger, or consolidation, "the fair market value as of that date" (sec. 202(b)). So in ascertaining the amount of depletion in the case of property acquired before March 1, 1913, the basis is the "fair market value * * * on that date," and in the case of property having a discovery value the basis is the "fair market value of the property at the date of the discovery, or within 30 days thereafter." (Sec. 214(a)(10); 234(a)(9).)

The provisions above quoted raise no necessary implication that property always has a "fair market value." The resort to "fair market value" in the case of discovery can be made only where the "fair market value of property is materially disproportionate to the cost"; that is, it must appear that the property has a "fair market value" and that such value is materially disproportionate to cost. There is no presumption that either fact exists. In the case of depletion of property acquired before March 1, 1913, "fair market value" is to "be taken in lieu of cost up to that date." The natural construction of this language is that "fair market value" is to be taken wherever possible, otherwise "cost up to that date." In ascertaining the gain or loss resulting from the sale or other disposition of property the purpose of valuing such property on March 1, 1913, is to determine the amount which must be withdrawn from the sale price in order to keep the capital intact. In the case of a sale or other disposition of property, not, however, including depletion (see Stanton *v.* Baltim Mining Co., 240 U. S., 103), it would be necessary to so withdraw the value of the property on March 1, 1913, even if there was no statutory provision therefor. See Doyle *v.* Mitchell Bros. (247 U. S., 179); Lynch *v.* Turrish (247 U. S., 221); Southern Pacific Co. *v.* Lowe (247 U. S., 330). The present statute must be construed as authorizing the withdrawal of such value. This result can be reached either by holding that all property had a "fair market price or value" on March 1, 1913, or by holding that "fair market price or value" is the statutory measure of the value to be withdrawn in any case in which the property has a "fair market price or value," but that where it has no such "fair market price or value" other means of measuring value must be resorted to. The latter interpretation gives to the words "fair market * * * value" their ordinary meaning, and, while recognizing that they have the same meaning throughout the statute, gives effect to the words "if any" in the paragraph under consideration. It seems, therefore, the more reasonable.

(Since "fair market price," if not synonymous with "fair market value" is narrower in its scope, it seems unnecessary to distinguish between the expression "fair market price or value" and "fair market value." While it is possible to construe the words "fair market" as modifying only the word "price" and not the word "value" in section 202(2), the use of the phrase "fair market value" in other parts of the statute seems to indicate that this is not the proper construction. It may be noted, however, that if this construction were adopted the same result would be reached as is reached on the lines developed in this recommendation.)

Some practical bearings of the construction herein given to the statute should be noted. Statements herein made are, however, far from exhaustive of a subject of special difficulty in the application of a general principle to specific cases. In determining whether property has a "fair market value" all available evidences must be considered. A case in which property has no "fair market value" should be regarded as unusual, and a determination that property has no "fair market value" should not be made lightly. Property is not without "fair market value" merely because there is a considerable divergence of opinion as to its value. "Fair market value" is to a large extent a matter of opinion and men of equally wise judgment will differ widely in their opinions. Frequently excellent evidence as to the "fair market value" of property, especially that which, though not ordinarily traded in, has a value in use, is found in its cost, or in the cost of reproducing it, with adjustments for depreciation and the like. (It should be noted, however, that while cost is frequently excellent evidence of "fair market value," "fair market value" may be either greater or less than cost and must, wherever made the statutory test, be taken regardless of its relation to cost.) As already pointed out, property can not be said to have no "fair market value" merely because no price therefor is established by public sales or sales in the way of ordinary business. Of course it is not essential that property be listed or traded in on any exchange in order that it may have a "fair market value." For example, stock in a small closely held corporation does not *ipso facto* lack "fair market value," nor does article 1563 of Regulations 45 so hold. Evidence as to the assets and liabilities of such a corporation and as to its earnings may furnish very definite indications as to its "fair market value." Even if a corporation is newly organized and has never done business as such, but has succeeded to the business of an individual or partnership, its stock will ordinarily have a "fair market value" ascertainable by reference to its assets and liabilities, the history of the specific business, and the history and conditions of the industry in general. Similar considerations apply to other kinds of property.

In any case in which it is found that property received in exchange has no "fair market value" and that, consequently, no gain or loss results from the exchange, the property received in exchange is to be treated as taking the place of the property exchanged therefor and takes as its value for the purpose of computing depreciation, depletion and gain or loss resulting from sale or other disposition, the cost, or the market value on March 1, 1913, or on the date of discovery, as the case may be, of the property exchanged for it. Property which has no "fair market value" for the purpose of determining gain or loss under section 202 (b) has no "fair market value" for any of the purposes of the Revenue Act of 1918.

It is held, therefore, that section 202 (b) of the Revenue Act of 1918 must be construed as recognizing that there are exchanges of property for other property which do not result in taxable gain or deductible loss for the reason that the property received in exchange has no "fair market value." A general statement as to the circumstances under which this is true is made in the body of this recommendation.

Section 202, Article 1564: Determination of gain or loss from exchange of property. 25–19–580. O. D. 308.

The exchange of old bonds of a corporation for bonds of a new issue having an extended maturity date and bearing a higher rate of interest does not fall within the provisions of article 1564 (b), Regulations 45.

Section 202, Article 1565: Exchange for different kinds of property. 2–19–143. O. D. 98.

No taxable income accrues on an exchange of bonds purchased prior to March 1, 1913, for 57 per cent of the face value of the old bonds in new bonds of the same company and 43 per cent in cash. The cash should be regarded as a return of part of the March 1, 1913, value of the old bonds, and the cost of the new bonds for the purpose of computing gain or loss in case of sale or other disposition of such bonds will be deemed to be the difference between the cash received at the time of exchange and the value of the old bonds on March 1, 1913.

Section 202, Article 1565: Exchange for different kinds of property.

(See 8–19–334, sec. 326, art. 836.) How gain or loss shall be determined where bondholders purchased at foreclosure sale property covered by the mortgage securing bonds, transferring said property to new corporation in exchange for its total authorized stock issue.

Section 202, Article 1566: Exchange of property and stock. 21–19–521. T. D. 2924.

Revenue act of 1918—Modification of articles 1566 and 1567 of Regulations 45.

1. Article 1566, of Regulations 45, first authorized April 17, 1919, is considered as not being warranted in law, and is hereby modified to read:

ART. 1566. *Exchange of property and stock.*—Where property is transferred to a corporation in exchange for its stock, the exchange constitutes a closed transaction and the former owner of the property realizes a gain or loss if the stock has a market value, and such market value is greater or less than the cost or the fair market value as of March 1, 1913 (if acquired prior thereto), of the property given in exchange. For the rule applicable where a corporation, in connection with a reorganization, merger, or consolidation, exchanges property for stock, see article 1567.

Section 202, Article 1566: Exchange of property and stock. 22–19–530. T. B. R. 71.

A dividend or distribution in liquidation made December 31, 1917, by a subsidiary corporation to a parent corporation represented a gain or loss to the parent company for the purpose of income tax in the amount of the difference between the distribution received by the parent company and the cost to it of the stock of the subsidiary company, or its value on March 1, 1913, if acquired prior thereto. Such gain, if any, is subject to income-tax rates applicable for the year 1917.

Section 202, Article 1567: Exchange of stock for other stock of no greater par value. 21–19–522. T. D. 2924.

Revenue Act of 1918.—Modification of articles 1566 and 1567 of Regulations 45.

2. Article 1567 of Regulations 45, as amended by Treasury Decision 2870, is amended to read as follows:

ART. 1567. *Exchange of stock for other stock of no greater par value.*—In general where two (or more) corporations unite their properties by either (*a*) the dissolution of corporation B and the sale of its assets to corporation A, or (*b*) the sale of its property by B to A and the dissolution of B, or (*c*) the sale of the stock of B to A and the dissolution of B, or (*d*) the merger of B into A, or (*e*) the consolidation of the corporations, no taxable income is received from the transaction by A or B or stockholders of either, provided the sole consideration received by B and its stockholders in (*a*), (*b*), (*c*), and (*d*) is stock or securities of A, and by A and B and their stockholders in (*e*) is stock or securities of the consolidated corporation, in any case of no greater aggregate par or face value than the old stock and securities surrendered. The term "reorganization," as used in section 202 of the statute, includes cases of corporate readjustment where stockholders exchange their stock for the stock of a holding corporation, provided the holding corporation and the original corporation, in which it holds stock, are so closely related that the two corporations are affiliated as defined in section 240 (*b*) of the statute and article 633, and are thus required to file consolidated returns. So-called "no-par-value stock" issued under a statute or statutes which require the corporation to fix in a certificate or on its books of account or otherwise an amount of capital or an amount of stock issued which may not be impaired by the distribution of dividends, will for the purposes of this section be deemed to have a par value representing an aliquot part of such amount, proper account being taken of any preferred stock issued with a preference as to principal. In the case (if any) in which no such amount of capital or issued stock is so required, "no-par-value stock" received in exchange will be regarded for purposes of this section as having, in fact, no par or face value, and consequently as having "no greater aggregate par or face value" than the stock or securities exchanged therefor.

Section 202, Article 1567: Exchange of stock for other stock of no greater par value. 12–19–396. T. B. R. 39.

REVENUE ACT OF 1918, SECTION 202.

1. Mere multiplication of the number of shares of a corporation (resulting from the exchange of four new shares, each having a par value of $25 for each old share of $100 par value) when not accompanied by conversion of surplus into capital stock or revaluation of assets, does not give rise to taxable gain or income to stockholders making the exchange.

2. Where a corporation amends its charter so that instead of having 10,000 shares of no-par value, the same stockholders will hold 100,000 shares without par value, neither the original charter nor the amendment having any stated capital in dollars, this multiplication of shares being not accompanied by conversion of assets into capital stock or any revaluation of assets, such a transaction does not give rise to taxable gain or income to stockholders making the exchange.

(A) A corporation, having an authorized and issued capital stock each share of which has a par value of 4xdollars, proposes, after appropriate amendment of its charter, in effect to divide such capital stock by reducing the par value of each share to xdollars per share, and by exchanging with each stockholder four new shares for one old share. Will the new shares constitute taxable income in the hands of the stockholders; and if so, to what extent?

(B) A corporation, having an authorized and issued capital stock represented by shares of no-par value, but having no stated capital in dollars, proposes, after appropriate amendment of its charter, to have such capital stock represented by an increased number of shares without par value, the new shares to be exchanged for the old on a basis of 10 to 1. No transfer of surplus to capital will be made in connection with the transaction. Will the new shares constitute taxable income in the hands of the stockholders; and if so, to what extent?

The corporation mentioned in paragraph (B) of the attached letter has been in existence for several years and is a going concern. No revaluation of its assets is contemplated in connection with the proposed transaction, and its surplus will be exactly the same after as before the issuance of the new shares. The object which is sought to be accomplished in cases (A) and (B) is identical; namely, to reduce the market value of each share of the corporations involved and to thus increase the marketability of all the shares.

The new shares will not constitute taxable income in the hands of the stockholders, or more accurately stated, neither transaction will give rise to gain, profit, or income taxable to the stockholders concerned.

Section 202, Article 1567: Exchange of stock for other stock of no greater par value. 10–19–353. O. D. 204.

For the purpose of determining whether any taxable income is derived by each individual stockholder of a corporation from such transactions as described in article 1567 of Regulations 45, the phrase "aggregate par value" as used in that article means the aggregate par value of stock of each individual stockholder exchanged for new stock and the aggregate par value of such new stock received by each individual stockholder.

Section 202, Article 1568: Determination of gain or loss from subsequent sale. 29–19–623. O. D. 335.

The word "or" as used in the phrase "stock or securities" in section 202(b) of the Revenue Act of 1918 is synonymous with the word "and" and when taken in connection with that section means that in case of a reorganization, merger, or consolidation of a corporation, a person may turn in either stock or securities, or both, and accept in exchange therefor either new stock or securities, or both, of no greater par or face value, without being liable for tax on any gain from such exchange.

Section 202, Article 1570: Readjustment of partnership interests. 10–19–354. T. B. R. 34.

(Also Section 218, Article 322.)

Recommendation as to the basis of individuals' tax liability where a distribution of partnership profits is made in securities carried in an investment account by the partnership.

On December 31, 1917, in accordance with a previous agreement, a partnership, distributed to its individual partners as their proportionate share of the profits for the year stocks and bonds having a book value of 9x dollars. These securities were carried in an investment account by the partnership and on the above-mentioned date it delivered to the individual partners all of the securities held by it, except x dollars in Liberty bonds, at current market prices on the exchange as at that date. The book value of the securities distributed was 9x dollars. The market value of these securities as of December 31, 1917, the date of distribution, was 8x dollars. The inquiry is as to whether this distribution is a bona fide sale within the meaning of Regulations 33, revised, the result of which would be to allow the partnership to claim the loss of x dollars, or whether it is a distribution of capital as between partners, the loss, if any, to be claimed by them as individuals upon the actual sale of the securities received in such distribution.

The books of the taxpayer show that the securities were actually distributed to the respective partners on account of their respective shares in the profits of the firm for the year ended December 31, 1917, the value being placed at the bid market price on December 31, 1917, in lieu of selling same through the exchange and distributing the proceeds. It is stated that the current earnings were sufficient to cover the distribution.

In any case the matter should be treated in only one way. Under the acts of September 8, 1916, and October 3, 1917, the members of a partnership are liable for income tax proper only in their individual capacities (although the partnership as such is liable under the Revenue Act of 1917 for excess-profits tax), and the share of the profits of the partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, was the amount which such partner was required to return for taxation. Under such circumstances the distribution of an asset by the partnership to a partner can not be regarded as such a sale or distribution as could result in a taxable gain or loss. To hold otherwise would for all practical purposes be tantamount to a holding that a person might sell at a profit or loss to himself, and we see no reason why this situation is in substance changed by the fact that for one year the partnership income was subject to excess-profits taxation as a unit. This is especially true where the asset in question consists of homogeneous securities which could be divided without materially changing their value. Had the partnership or the partners wished to make an actual sale and realize an allowable loss, the securities doubtless would have been sold to outside parties. Moreover, it is significant that the department holds, even in the dissolution of a partnership, that if a partnership distributes its assets in kind, the partner realizes no gain or loss until he disposes of the property received on distribution (art. 1570, Regulations 45, Revenue Act of 1918). The same conclusion follows *a fortiori* when the partnership in the course of dividing its profits, distributes certain assets among its members.

The Advisory Tax Board, therefore, recommends that, first, each partner be taxed on the basis of his distributable share of the partnership profits for the year 1917, which partnership profits will be ascertained without claiming any loss with regard to the unsold securities held in the investment account of the partnership; and second, that the individual partners receiving these securities as a distribution of partnership profits shall determine their future gain or loss when such securities are sold and on the basis of the cost of the securities to the partnership or their market value on March 1, 1913, if acquired before that date.

Section 203.—INVENTORIES.

Section 203, Article 1582: Valuation of inventories.

(See 4–19–211, sec. 212, art. 23.) Estimated inventories.

Section 203, Article 1582: Valuation of inventories. 16–19–457.
T. B. R. 48.

The valuation of inventories upon the basis of average cost is not in accord with the provisions of the acts of October 3, 1913, September 8, 1916 (including this act as amended October 3, 1917), and the revenue act of 1918, and where used amended returns may be required.

Request has been made for advice as to whether the average cost method of taking inventories used by certain corporations is permissible under the act of September 8, 1916, or under the act of October 3, 1917. Briefly stated, the method in question is as follows:

Materials purchased during a month are added, both as to quantity and cost, to the quantity and cost balance brought forward from the previous month, and an average cost to the close of the month is computed by dividing the total quantity into the total money figures. This average is then applied to the quantity of materials used for manufacture during the month, and the amount so computed is credited to the material account. This process is a well-established custom, which has been adopted by the leading concerns of the trade. The importance of the question in the particular instance now under review lies in the fact that materials purchased are not currently consumed in manufacture, but are held for ageing purposes anywhere from, say, one to three years. Furthermore, prices are subject to substantial fluctuations. Under these circumstances does an inventory thus computed form a proper factor for the computation of taxable net income under the acts of September 8, 1916, and October 3, 1917? It may be well to consider also whether the method is satisfactory under the Revenue Act of 1918. Neither the act of 1913 nor the act of 1916, including amendments of October 3, 1917, make any direct mention of inventories, and it is not until the act of 1918 that any statutory rule is laid down. Section 203 of that act provides as follows:

SEC. 203. That whenever, in the opinion of the Commissioner, the use of inventories is necessary in order clearly to determine the income of any taxpayer inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Under both of the previous acts, however, the regulations recognized that inventories are essential factors in the computation of gross income, and Regulations No. 33, article 161, issued January 5, 1914, made the following provision therefor:

ART. 161. In order that certain classes of corporations may arrive at their correct income, it is necessary that an inventory, or its equivalent, of materials, supplies, and merchandise on hand for use or sale at the close of each calendar year shall be made in order to determine the gross income or to determine the expense of operation.

A physical inventory is at all times preferred, but where a physical inventory is impossible and an equivalent inventory is equally accurate, the latter will be acceptable.

An equivalent inventory is an inventory of materials, supplies, and merchandise on hand taken from the books of the corporation.

Regulations No. 33, revised (issued Jan. 2, 1918), require the use of inventories but do not lay down any rules as to the basis upon which they are to be valued. Treasury Decision 2609 was issued on December 19, 1917, and laid down for the first time the rule that inventories might be valued upon the basis of (*a*) cost or (*b*) cost or market, whichever is lower. Before this Treasury decision the working rule of the department was that inventories should be taken upon cost, but this rule did not find expression in the regulations nor in any Treasury decision, nor did it appear upon the return forms until the revision of Form 1031, in October, 1916. Treasury Decision 2609 is, therefore, the first authoritative pronouncement upon the subject, and the rule laid down by it is applicable to both the 1913 and the 1916 acts, and it has been incorporated in Regulations 45. The rule then being that inventories may be taken upon the basis either of (*a*) cost or (*b*) cost or market, whichever is lower, does the average method come within either of these bases, or does it furnish a new basis which should be recognized as satisfactorily reflecting annual net income?

Commercial practice sanctions the custom of an annual accounting for profits or losses, and the income tax laws have required such annual accounting. It must be admitted, however, that such a computation is not only difficult, but that a year is in many businesses a period too short to be satisfactory. The processes of production ofttimes require more than a year in their course, and the fluctuations in volume of business and other items tend to distort the financial results of individual years. An able English jurist has held in effect that annual income is either a conventional figure or a mere approximation. This statement, however, like many other striking phrases, is more true in its suggestiveness than in its reality. Whatever the difficulty and whatever the degree of accuracy in attaining it, the object to be kept in view is the ascertainment of the profits during the year which have been realized upon sales actually made, inasmuch as profits can arise only through the sale or exchange of property. The value of merchandise or other property may increase while in the hands of the owner, but mere appreciation in value is not profit. To be profit the appreciation must be realized by passing through the door of sale or exchange. Appreciation may become profit, and it does do so when realized. It may, and frequently does, fail to realize. The logical method of computation is, therefore, to apply against the total sales of the period the cost of the goods covered by such sales, and the difference between these two amounts represents gross profits. Precisely this is accomplished when inventories are taken upon the basis of cost.

A loss, although seemingly the opposite of a profit, may, however, fall under a different rule. A loss may be occasioned by physical destruction or deterioration of property included in an inventory or it may be attributable to changes in styles or other causes affecting salability, or it may be occasioned by shrinkage in market value. Where such losses arise, even though not fully consummated by a sale of the goods, the fact should nevertheless be recognized, and when such goods are taken in an inventory they may, if the taxpayer so elects as a consistent policy, be valued at market instead of cost, where market is lower. This is true even in spite of the possibility that conditions may change, and at a date before a sale is made the goods may again be worth their original cost. Income must be a thing sufficiently real to be capable of being taken out of a business by its owners without impairment of capital. It is to be noted, however, that corporations can seldom distribute currently all of their profits, and that the considerations governing the payment of dividends are not applicable to the computation of profits. The exact point at which an impairment of capital begins is one that can not easily be determined with precision, and questions of doubt as between income and capital must be resolved in favor of capital. In a very real sense losses may be admitted, while profits must be proved. Capital once impaired is gone, but the admission of a loss not fully realized by a completed transaction results in nothing more serious than a postponement of profit to a subsequent period. The imposition of an income tax in effect compels a withdrawal of a portion of the income from the business, and the tax is imposed ratably upon all net income, so that if through an error in computation a stated figure of income includes any amount of capital the tax is imposed not upon income but upon capital. The rule of cost or market, whichever is lower, even though it may appear to lack in consistency, thus, nevertheless, rests upon solid ground, and its widespread adoption throughout the business world amply justified its adoption for tax purposes.

As already indicated, the starting point in the computation of annual income must be the sales made during the year. It is the profits or losses upon these sales that are to be computed if any actuality is to be attained. To do otherwise is to invite speculation and confusion. To give annual profits and losses meaning and integrity they must be arrived at by a logical computation which recognizes that each year acquires from its predecessor certain potentialities and turns over to its successor the property as it exists at the end of the year, and it scarcely needs to be said that the basis of valuation at the beginning and end of the year must be reasonably uniform. If the starting point in the computation of annual profit or loss is the sales made during the period, the next step is the computation of the amount that is to be charged against such sales in respect of the cost of the goods that have gone into the sales. This must include (1) the cost of the goods included in the sales, less any portion of such cost which may have in effect, through a previous inventory based upon a market lower than cost, been charged against the sales of a previous year, and (2) where as a consistent policy inventories are taken upon the basis of market when it is less than cost, such further amount, if any, as may be required to reduce the goods in the inventory to the level of a lower present market. To charge against the sales of a year a sum less than the total found under (1) and (2) above will show as profits an amount larger than the profits actually realized upon the sales of the period. In a business requiring goods to be carried for lengthy periods and where an average method of inventory valuation is used, this overstatement of profits will occur whenever the current market is declining, while on an advancing market the profits on the actual sales of the year will be understated. When the market is stable the average method will reflect with approximate accuracy the true profits, and in a business in which the turnover is rapid, the effect of such a method upon the computation of annual income is small as compared with a business in which it is necessary to carry goods, such as raw materials, for long periods. In such cases, so long as the annual profits are stated with substantial accuracy, taxpayers should not be required to make inventory changes which are annoying to them and which are without commensurate importance to the Government. The average cost method of inventorying may, however, have an important effect upon taxation, and in the cases now under consideration it appears to have a material bearing upon the amount of the tax. The computation of net income upon such a basis results in an assignment of income to a year, not upon the basis of the transactions of the year, but upon the basis of transactions part of which spread over more than a year. To be strictly logical, such a method should, moreover, include a similar averaging of sales. This would tend toward uniformity of annual profits and might, in fact, reflect the profits as accurately as the partial average method, but it would be a far departure from an actual computation. An annual accounting period is a fundamental requirement of the Federal income-tax legislation, and every computation of taxable net income must be made in conformity therewith. This the average cost inventory method failed to do, and its use can not be approved as meeting the statutory requirement.

The Advisory Tax Board is, therefore, of the opinion that the average cost inventory method does not conform to the requirements of the act of October 3, 1913, the act of September 8, 1916 (including this act as amended October 3, 1917), and the Revenue Act of 1918, but, having regard to the fact that in the earlier years taxpayers were not advised as to the basis upon which inventories should be taken, and that returns have been made to and accepted as satisfactory by the department in many cases in which such an average cost inventory method has been used, the board recommends that no revision of net income be made in years prior to 1917 in cases where taxpayers have, as a matter of consistent practice used an average cost inventory method. Amended returns should be filed or other proper correction made in the case of returns for the taxable year 1917 or any subsequent year in which the income through the use of such an average cost inventory method is materially larger or smaller than it would be if computed on the basis of an inventory correctly valued.

Section 203, Article 1582: Valuation of inventories. 22–19–531.
T. B. R. 65.

Revenue Acts of 1917 and 1918.—The base-stock method of taking inventories is not warranted by the law or the regulations.

The question is raised as to whether under the Revenue Acts of 1917 and 1918 the so-called "base stock," "minimum," or "cushion," hereinafter referred to as "base stock," method of taking inventories may be used.

Section 203 of the Revenue Act of 1918 provides as follows:

That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Article 1582 of Regulations 45 provides in part that:

Inventories should be valued at (a) cost, or (b) cost or market, whichever is lower.

According to the base-stock method of taking inventories a manufacturer or dealer values at the same price year after year the minimum quantity of goods which he must have on hand at all times. If this method is accepted as sound, a second question arises as to the method of determining this price. In the present case the closing inventory for the year 1916 was adopted as the minimum basis for quantity and unit of price, though there was some modification in the following year for new lines of goods.

Clearly the base-stock method of taking inventories is not within the terms of the regulations—that is, it is not such a basis as the Commissioner, with the approval of the Secretary, has prescribed. It remains to consider, however, whether such a method should be so prescribed "as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The facts before the Advisory Tax Board do not warrant the conclusion that there has been any general adoption of the base-stock method of taking inventories as an "accounting practice," or that it has had any considerable recognition as the "best" accounting practice. On the contrary, it is certain that the method has not been widely adopted. The argument from usage is against rather than in favor of it. To sanction this method of inventorying in the case of the very small minority of taxpayers who have used it—some like the appellant, only for the last year or two—would work an unjustifiable discrimination against the great majority of the manufacturers and dealers who have not used it. Returns for 1918 must be made in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, provided this method clearly reflects the income (sec. 212 (b)). Probably more than 95 per cent of the manufacturers and dealers in this country—certainly a very large majority of them—keep their books in accordance with methods other than the base-stock method. Unequal and discriminative treatment of this kind is to be avoided whenever possible. The "best accounting practice" set up in section 203 as the guide or standard for the commissioner must be a practice which not only clearly reflects the income but which has been "regularly employed," presumably for a number of years, by a majority of the taxpayers involved. A procedure to become a "practice" must be widely used and must have withstood the changing tests of time. Practically none of these tests is met in the present appeal. In particular, the fact that so few business concerns use the base-stock method is strongly suggestive of the truth that it does not truly reflect the income.

That it is a truth appears as clearly upon analysis as upon an examination of trade practice. The present Federal income-tax system is based upon an annual accounting period. The object of an inventory is to assign to an annual accounting period its profits and losses. The effect of the base stock inventory method is to assign all profits and losses in respect of the minimum inventory to the year in which such inventory is liquidated. This result is accomplished through ignoring sales and exchanges of individual items of the inventory and treating the minimum inventory as a unit. Each sale or exchange of property for other property having a market value is, however, in fact a realization of taxable profit or deductible loss in the year in which it occurs and a method of accounting which disregards such realization does not truly reflect income. Such profit is not, as suggested by counsel, unrealized appreciation. It is none the less taxable profit because immediately reinvested in inventory. (Moreover, such reinvestment is not an operating expense but, on the contrary, is an expenditure for working assets.) Similarly, loss so realized is none the less deductible loss even though the inventory is not reduced in quantity. In some cases highly conservative business concerns reckon *trading profits* by comparing current costs with current sales, disregarding basic inventory gains as quasi-capital gains; but even such concerns do not ordinarily disregard inventory losses. This makes it clear that the basic stock method is a mere counsel of conservatism, which ignores quasi-capital gains from motives of prudence. We do not believe that profit from the sale of a basic or minimum inventory is ordinarily a capital gain, but whether it is or not such gains when arising in an annual accounting period by reason of transactions which, taken by themselves, constitute realizations of profit or loss can not be disregarded under American (as distinguished from British) income-tax laws. To disregard them is to overstate or understate, as the case may be, profits for the annual accounting period. Where the base stock method is used it is true, as was stated in Advisory Tax Board Recommendation 48 with respect to the average cost inventory method that "in a business requiring goods to be carried for lengthy periods * * * this overstatement of profits will occur whenever the current market is declining, while on an advancing market the profits on the actual sales of the year will be understated." The Advisory Tax Board, therefore, concludes that the base stock inventory method does not "most clearly" reflect income. For a more complete discussion of the subject of inventories see the Advisory Tax Board recommendation above referred to.

The fundamental theory underlying this method is unsound. While the taxpayer in question happened to adopt 1916 prices in introducing this method of inventorying, the usual practice and general object of the basic method is to get the base or constant stock at a figure below cost and hold it there. It arises not from a desire to measure capital and net income accurately, but to play safe, stabilize profits, and provide reserves against possible future losses. It is a result of essentially the same policy and theory which lead bankers to write down their buildings to a nominal figure and to accumulate hidden reserves. These practices have never been allowed by income-tax law and procedure in the case of banks. They can not be allowed in the case of manufacturers. Excessive conservatism in measuring or accounting for capital and income may be nearly as deleterious as the excessive optimism which in the past led some corporations to overstate profits. The latter leads to bankruptcy. The former leads to various evils and brings retributive penalties when occasion arises to measure capital (or "invested capital") for the purposes of rate making, profit, regulation, and the determination of excess-profits taxes.

The base stock inventory is suggested as a method of equalizing gains and losses over a period of abnormal price conditions. In substance it results in offsetting an inventory gain of one year against an inventory loss of another rather than in assigning to each year its true gain or loss. The fact that the revenue act of 1918 in its provisions with respect to inventory loss and net loss (sections 204, 214 (a) (12), 234 (a) (14), authorizes in some cases the carrying of a loss realized in one year into accounts of another year is some indication that Congress did not intend that the ordinary inventory provisions should be construed to authorize such a transfer. Furthermore, the argument that the application of the ordinary rules as to inventories results in hardship is met by the fact that Congress has authorized relief against hardship through the medium of these inventory and net loss provisions in cases which are within the terms thereof.

The general importance of this subject makes it worthy of note that a distinguished British commission—the Committee on Financial Risks Attaching to the Holding of Trading Stocks—after a thorough investigation and analysis of this subject, decided against the base-stock method of inventorying in its report submitted December 5, 1918. (Cd. 9224, 1919.) "Accountants," the committee found in Great Britain; "with a few exceptions, consider that these practices (the base-stock method of inventorying and the practice among bankers of writing down buildings, accumulating secret reserves, etc.) misrepresent the facts. In good times large profits are made. If it is desirable to make reserves against the future, part of the profits realized should be set aside as reserves and so denominated. If goods have been bought for £50 and their market price has not fallen below £50 at the time of striking a balance, it is a misuse of language and a travesty of fact to write their value down to £20 out of profits made by selling something else. The correct procedure, it is maintained, is to place the difference of £30 to reserve." And again, referring to the fact that the British Board of Inland Revenue has felt compelled under court decisions to recognize the base-stock method in certain industries, the committee adds: "And it appears that in the absence of a statutory definition the Board of Inland Revenue has felt itself unable to contest the base-stock system of valuation where it has prevailed. As the practice is repugnant to the views which Government and the majority of this committee hold as to the correct system of accounting, * * * this concession has not been extended beyond the point of obligation."

The reasons above stated lead to the conclusion that the base-stock method does not conform to the requirements of the Revenue Act of 1918. This conclusion does not, of course, preclude a taxpayer who values his inventory at cost and who retains identifiable goods year after year from attaining the result with respect to the identifiable goods so retained which would be attained through the use of the base-stock inventory method.

The general conclusion that the base-stock method does not conform to the requirements of the Revenue Act of 1918 applies to "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices." According to article 1582 of Regulations 45, such goods "will be deemed to be the goods most recently purchased." The warrant for this presumption or inference is that in the absence of evidence as to the actual fact in the specific case it is, as conceded by counsel for the taxpayer, more nearly true than any other. This presumption or inference is, therefore, not only warranted but required by the statute which in authorizing the Commissioner, with the approval of the Secretary, to prescribe a basis upon which inventories shall be taken requires him to prescribe such basis as "most clearly" reflects the income. Conversely, he can not properly prescribe that "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices" will be deemed to be the goods included in the minimum inventory.

It is suggested in behalf of the taxpayer that if the base stock method is not approved, some alternative method should be prescribed other than the valuation of inventories as required by the present regulations at cost or market, whichever is lower. One method proposed is that inventories be valued on a moving average basis over a period of five years, more or less. According to this method one-fifth, for example, of the inventory would be deemed to be the goods most recently purchased, and the balance the goods on hand at the beginning of the year. Another method proposed is that the goods in the inventory be deemed to be the earliest rather than the latest purchases. These methods are open to the same objections as is the base stock method. Inventories valued according to these methods would not as clearly reflect the income assignable to an accounting period as do inventories valued according to the present regulations.

Most of the reasoning above set forth with respect to the Revenue Act of 1918 applies to the Revenue Act of 1917. The Advisory Tax Board finds nothing in the earlier statute to warrant the use thereunder of methods of valuing inventories which can not be used under the later statute.

The Advisory Tax Board is of opinion, therefore, that neither the base stock method of taking inventories, nor the moving average method, nor a method based upon the presumption that goods in the inventory are the earliest purchases, is in conformity with the provisions of the Revenue Act of 1917 or of the Revenue Act of 1918, and recommends that no change be made in the present regulations with respect to the method of taking inventories.

Section 203, Article 1582: Valuation of inventories. 6–19–269.
T. B. M. 31.

Appeal of the X Co. from the ruling of the Income Tax Unit relative to inventories should be denied.

The X Co. conducts a retail business and since its organization has taken its inventory upon the basis of the average of the market prices over a period of five years prior to its organization. For a number of years these prices represented approximately cost or current market price, because the fluctuations in prices were relatively small. In more recent years these price fluctuations have been greater and at the close of 1918 the conventional price which was again used in computing the inventory bore little relation either to cost or to the current market price. The method used by the taxpayer does not conform to the regulations, nor can it be said clearly to reflect true net annual income. The Income Tax Unit has held that for the years 1917 and 1918 the X Co. should recompute its inventories in accordance with Articles 1581-1585 of Regulations 45, and that amended returns for these years should be made in accordance therewith, and in the opinion of the Advisory Tax Board this decision should be confirmed.

Section 203, Article 1582: Valuation of inventories.

(See 1–19–10; sec. 202, art. 1561.) **Inventory values in connection with determining gain or loss on sale of property.**

Section 203, Article 1582: Valuation of inventories.

(See 5–19–245; sec. 202, art. 1561.) Valuation of inventories in the case of goods acquired prior to March 1, 1913.

Section 203, Article 1582: Valuation of inventories.

(See 6–19–268; sec. 212, art. 23.) Valuation of inventories in returns filed by farmers.

Section 203, Article 1583: Inventories at cost. 28–19–610.
(Also Section 213(a), Article 35.) O. D. 326.

Taxpayers who as a matter of settled practice do not deduct cash discounts from purchases, but who take the merchandise purchased into their inventories at invoice price (less trade or other discounts other than strictly cash discounts), carrying the discounts in a discount account, may not, in valuing their closing inventories for income tax purposes, deduct from the invoice price of the merchandise on hand at the close of the taxable year the average amount of cash discount received on such merchandise; neither may the amount of cash discount earned, to be reported as income, be decreased by an amount representing the estimated cash discount received on merchandise on hand at the close of the year.

Section 203, Article 1585: Inventories by dealers in securities. 1–19–14. O. D. 8.

A dealer in securities as referred to in section 203, article 1585, Regulations 45, may inventory his unsold securities on hand at the beginning and end of the taxable year, either (*a*) at cost, or (*b*) at cost or market value whichever is lower, and such inventory may be taken into consideration in arriving at income tax liability.

Where, however, a taxpayer is not a dealer in securities the market value of Liberty loan bonds, held by him is not to be taken into consideration as income tax liability and any profit or loss in connection with the bonds is to be accounted for in the year the bonds are disposed of.

Section 203 Article 1585: Inventories by dealers in securities.

(See 24–19–558; sec. 212, art. 23.) Inventories in connection with "short sales" of stock.

Section 204.—NET LOSSES.

Section 204, Article 1601: Scope of net losses.

(See 3–19–188; sec. 234, art. 561.) Application of section 204 in case of losses due to payment of liquidated damages.

Section 204, Article 1601: Scope of net losses.

(See 11–19–370; sec. 212, art. 26.) Consideration of change in accounting period in connection with the provisions of section 204.

Part II.—Individuals.

Section 211.—SURTAX.

Section 211, Article 13: Surtax on sale of mineral deposits. 3-19-176 T. B. R. 8.

Income tax—Revenue Act of 1918.—Where individuals transfer property to a corporation which later demonstrates the principal value of such property as oil-producing property "by prospecting or exploration and discovery work" and then dissolves transferring the property to the individuals, who remain stockholders without change in interests, and such stockholders sell the property, the portion of the surtax attributable to such sale is not limited to 20 per centum of the selling price of such property or interests under the provisions of section 211, subdivision (*b*).

The X Co. and the Y Co., owners of certain producing properties, propose to sell such properties to the Z Co. It is assumed, though not here decided, that "the principal value of the property" owned respectively by the X Co. and the Y Co. "has been demonstrated by prospecting or exploration and discovery work" within the meaning of that phrase as used in section 211, subdivision (*b*), and section 337 of the Revenue Act of 1918. It is conceded by these corporations that this work was done by them. The question raised is whether under the circumstances of this case if the corporations should dissolve and distribute their assets—the producing properties—in kind among their stockholders, and the sale should thereafter be made by them, such stockholders would be entitled to the benefit of the provision contained in section 211 (*b*), that "the portion of the tax imposed by this section"—that is, the surtax upon net income of individuals—"attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest."

The circumstances of this case are that the original incorporators of each of the corporations owned property and conveyed it to the corporation prior to the demonstration of its principal value as producing property "by prospecting or exploration and discovery work," which was done by the corporation, and that such incorporators have continued to be the only stockholders of such corporations without change in their stock holdings. The argument is advanced that the corporations were organized "merely for purposes of business convenience" and that they are in substance nothing more than incorporated partnerships.

The Income Tax Unit ruled that under the circumstances stated "the corporate entities must be recognized and are the only interests which would be entitled to be recognized as discoverers, and that consequently the taxable profits made by the tenants in common upon the sale of properties received in liquidation would not be limited to 20 per cent of the selling price under the provisions of section 211 (*b*)."

The Advisory Tax Board recognizes that in some instances the court has looked through the form to the substance and has disregarded corporate entities (see Southern Pacific Company *v.* Lowe, 247 U. S., 330; Gulf Oil Corporation *v.* Lewellyn, 248 U. S., 71), and that Congress has done likewise. (See, for example, provisions as to consolidated returns, Revenue Act of 1918, sec. 240.) The situations so dealt with by the court and by Congress, however, differ widely from that here under consideration, and those analogies do not warrant departure in the present case from the ordinary rule that a corporation is an entity distinct from its stockholders. Under this ruling the corporations, and not their stockholders, are entitled to the benefit of "discovery value" of the property in question whether for purposes of depletion or of sale.

It is recommended, therefore, that the conclusion of the Income Tax Unit that under the circumstances describes the stockholders of the X Co. and of the Y Co. would not be entitled to the benefit of the limitation contained in section 211 (*b*), be approved.

Section 211, Article 13: Surtax on sale of mineral deposits. 9–19–337. O. D. 194.
(Also Section 219, Article 344.)

Where trustees of assets of an oil company sell mine, oil, and gas wells, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by said trustees section 211(b) Revenue Act 1918 is applicable in computing tax upon income from such property held in trust. Such income being taxable to trustees as an entity is free from tax when distributed to beneficiaries.

Section 212.—NET INCOME DEFINED.

Section 212, Article 22: Computation of net income. 1–19–18.
(Also Section 213(a), Article 52.) O.D.9.

Adjustments made in accordance with instructions from the Interstate Commerce Commission, increasing the income of a railroad corporation from transactions in prior years and taken up on the books of the corporation during the taxable year because necessary information was not available prior to that time, represent income for the years during which the transactions took place instead of the taxable year. Corrections should be made by means of amended returns.

Section 212, Article 23: Bases of computation. 8–19–312. T. D. 2873.

Modification of article 23, Regulations 45, bases of computation of net income.

Article 23. Regulations 45, is modified to read as follows:

ART. 23. *Bases of computation.*—(1) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. (See sec. 200 of the statute for definitions of "paid," "paid or accrued," and "paid or incurred.") All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. For instance, in any case in which it is necessary to use an inventory no accounting in regard to purchases and sales will correctly reflect income except an accrual method. (See sec. 213(a) of the statute.) A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See art. 53.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through conversion of the property.

(2) For the taxable year 1918 the true income, computed under the revenue act of 1918 and where the taxpayer keeps books of account in accordance with the method of accounting regularly employed in keeping such books, shall in all cases be entered in the return even though this results in apparent omissions or duplications of particular items of income or expense. In the ordinary case such omissions and duplications are more apparent than real and are likely to counterbalance one another, so that the change in the basis of reporting calls for no material adjustment. Where, however, the method previously employed by the taxpayer in determining his income subject to the tax is materially different from the method regularly used by the taxpayer in keeping his accounts, or where for any reason the basis of reporting income subject to tax is changed, the taxpayer should attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the results of such change. Where, for example, a taxpayer who, prior to 1918, has reported on the so-called receipts basis is compelled under the above rule to report on the so-called accrual basis, he should include in the separate statement the following information:

First, (a) expenses paid before the end of the taxable year 1917, but not accrued at that date; (b) income accrued at the end of the taxable year 1917 but not received at that date; (c) expenses accrued at the end of the taxable year 1917 but not paid at that date; (d) income received before the end of the taxable year 1917 but not accrued at that date; and

Second, similar items as of the end of the taxable year 1916.

If in the opinion of the Commissioner such information indicates that the returns for any previous years did not reflect the true income, amended returns for such years will be required.

(3) A taxpayer who changes the method of accounting employed in keeping his books for the taxable year 1919 or thereafter shall, before computing his income upon such new basis for purposes of taxation, secure the consent of the commissioner. Application for permission to change the basis of the return shall be made at least 30 days in advance of the date of filing return and shall be accompanied by a statement specifying the classes of items differently treated under the two systems and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change.

(4) *Bank discounts.*—Banks which in the past have treated discount as income before it was actually earned, and during the taxable year 1918 have placed the discount account upon an accrual basis, will be required to submit the information called for in paragraph 2 above and submit an amended return for the taxable year 1917, and will be permitted to submit (or the commissioner may require) amended returns for all prior years during which the taxpayer was subject to tax. Additional taxes for prior years found to be due upon such reexamination will be paid upon the basis of the amended returns in the ordinary way. Where it appears that prior taxes have been paid in excess of the amount properly due, such excess will, to the extent possible, be credited against future income and profits taxes under the provisions of section 252 of the revenue act of 1918.

Section 212, Article 23: Bases of computation. 6–19–268.
(Also Section 203, Article 1582.) O–844.
(Also Section 213 (a), Article 38.)

INCOME TAX RETURNS OF FARMERS ON ACCRUAL BASIS.

A farmer who keeps books of account on an accrual basis may make returns of income upon the basis of his books of account.

Articles 22, 23, 24, and 38 of Regulations 45, contain the rulings of this office relative to returns of income by taxpayers.

A farmer produced a crop in the year 1917, prepared his individual return for said year on a cash basis, set up an inventory as of January 1, 1918, having on hand crops to the value of 2x dollars which subsequently is treated as a credit against his income for the year. No tax has been paid upon this amount. This amount is not included in the return for the year 1917 and is being used as a credit, as goods on hand at the first of the year 1918.

The rule applicable to all industries is that inventories should be taken on the basis of "(*a*) cost, or (*b*) cost or market, whichever is lower." It is recognized that in some industries the actual cost of production can not be ascertained accurately, and it is therefore necessary to approximate a cost value by using selling market prices as a starting point and reducing such selling market prices in each case by an amount sufficient to eliminate the element of profit. This rule is applicable to the inventories of farmers and stockmen, and is widely used in many lines of industry, notably in those types of mining and manufacturing in which a product of more than one grade or more than one kind is obtained by a common operation. Under its application a result can be reached that fairly approximates the inventory basis laid down in the regulations as stated above.

In this case the taxpayer is not required to return as taxable income for the year 1917 any part of the value of his crops on hand at the close of the year. If he uses an inventory method of keeping his books of account he may not value these crops in excess of the cost (which has been capitalized and not charged to expense) of raising them. In no case is a taxpayer permitted to value his inventory at more than the capitalized cost and where the cost or market (whichever is lower) basis is used and the market value is less than the capitalized cost the market value must be used.

Section 212, Article 23: Bases of computation. 24–19–558.
(Also Section 202, Article 1561.) S–1179.
(Also Section 203, Article 1585.)
(Also Section 214, Article 144.)

Where a taxpayer has "borrowed" stock in order to make a "short sale" the gain or loss arising from such transaction can not be accrued upon the books of the taxpayer at the close of his taxable year by treating as an offsetting obligation the market value of the stock sold "short" as of that date; the gain or loss is determined when the amount of stock sold "short" is repurchased for return to the lender and the transaction closed.

Opinion has been requested as to whether the profit or loss, as the case may be, on a "short sale" accrued as of the close of the tax year, determined by treating as an offsetting obligation the market value as of that date, of the securities sold "short," may be taken into account in arriving at the amount of net income subject to tax for that year.

Section 203 of the Revenue Act of 1918 provides:

That whenever in the opinion of the Commissioner the use of inventories is necessary in order to clearly determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Section 214 (a) (4) and (5) provides:

That in computing net income there shall be allowed as deductions:

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business.

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with a trade or business; * * *.

In the case of short-sales transactions substantially the following occurs:

A sells to B 100 shares of stock, executing a memorandum of sale. Under the rules of the exchange the shares have to be delivered and paid for the day following. If the sale is a short sale A applies to C, who has such shares on hand, for a "loan" of them. C being willing to lend them, delivers to A a certificate for 100 shares indorsed in blank on A's agreement to redeliver to him an *equivalent number* of shares on demand on any business day and the deposit with C by A of the market value of the shares as security for their return. That deposit remains until an equal number of shares are returned, subject to increase from day to day if the market value of the stock rises, and to decrease from day to day if the market value of the stock falls. A makes his delivery under his transaction with B by delivering the certificate which he has borrowed from C for that purpose, thereby completing the transaction between A and B. When A desires to return the shares which he has "borrowed," A goes into the market and buys 100 shares for the purpose of delivering them to C. These shares acquired for delivery to C he delivers to C and receives the amount he has on deposit with C. (Todman, Brokerage Accounts, p. 51; Opinion Attorney General dated Mar. 23, 1918.) The question now arises as to whether a taxpayer may take into account, at the end of the year, accrued profits or losses upon short sales based upon a fall or rise in the market value of securities sold short.

Under section 203, supra, a dealer in stocks may inventory unsold securities on hand either at cost, or at cost or market, whichever is lower, and may make his return upon that basis, provided that method is used for all his securities, and adhered to for subsequent years. This inventory method of accounts may be availed of by dealers, however, only as to stocks *owned* by the dealer at the end of the year. (Arts. 1581 and 1585, Reg. 45.) It becomes important to determine, therefore, whether the dealer in making a short sale has anything which he may inventory at the end of the year within the above ruling.

There can be no doubt that the legal title to stock is transferred from the lender to the borrower and from the borrower to the buyer, and then later from the borrower to the lender in the short sale transaction described above. "Shares of stock are fungible things, and their loan with an agreement to return things of the same class is the mutuum of Roman law, as to which no one can doubt that title passed from the lender to the borrower and vice versa. (Jones on Pledges, p. 64; Story on Bailments, 7th ed., sections 283, 284; Kent's Commentaries, 12th ed., Vol. II, p. 573; Hurd *v.* West, 7 Cowen (N. Y.) 752, 756)." (Opinion Attorney General dated Mar. 23, 1918.) The short sale dealer, in open short sales, having no stock in his possession to which he has *title*, consequently has no stock which he can inventory at the end of the year; as soon as title was secured from the lender it was passed on to the buyer.

The statute nowhere authorizes the inventorying of liabilities, and this is true even though the liability is one to return specific property in kind on demand. Such a liability is exceptional in character. However the word "inventory" in its commonly accepted commercial usage, refers to the inventorying of assets only. (23 Cyc. 347; Peet *v.* Dakota Fire and Marine Ins. Co., 1 S. D. 462, 47 N. W. 534; Hatfield Modern Accounting, p. 75.) Section 203 should not be construed to authorize the inventorying of liabilities.

Under section 214, supra, losses sustained during the taxable year, not covered by insurance or otherwise, are deductible if incurred in trade or business or in any transaction entered into for profit. For such losses to be deductible in any taxable year, however, they must be evidenced by *closed* and *completed* transactions. (Art. 141, Reg. 45.) Applying these principles to the present case, it is clear that a taxpayer making a short sale can not know whether he has suffered a loss or made a gain until an *equivalent number* of shares of the stock borrowed for that purpose has been repurchased and returned to the lender. The accuracy of any gain or loss accrued upon the books of a taxpayer making short sales would depend upon the cost of the stock at the time it is purchased for return, and, it is apparent that this cost can not be foreseen; open short sales are not, consequently, such closed and completed transactions as are contemplated by the regulations above referred to. (Compare Art. 144, Reg. 45.)

It must be held, therefore, that where a taxpayer has borrowed stock in order to make a short sale the gain or loss arising from such transaction can not be accrued upon the books of the taxpayer at the close of his taxable year by treating as an offsetting obligation the market value of the stock sold short as of that date; the gain or loss is determined when the amount of stock sold short is repurchased for return to the lender and the transaction closed.

Section 212, Article 23: Bases of computation. 4–19–211.
(Also Section 203, Article 1581.) O. D. 133.

A taxpayer who for many years has elected to take inventory only every two years, and used an estimated inventory in the return for the intermediate year, making any necessary adjustments in the return for the following year when an actual inventory was taken, may not apportion his total earnings for the two years 1917 and 1918 equally between such years for income tax purposes.

Section 212, Article 23: Bases of computation. 23–19–541.
O. D. 289.

Taxpayers will not be permitted to adopt one period for inventorying and closing their books applicable to one part of their business and a different period applicable to another part thereof.

Section 212, Article 25: Accounting period. 2–19–146.
O. D. 100.

An act, passed in 1918 by the Maryland Legislature, requires public-service corporations to keep their accounts on a calendar-year basis. Such corporations which have been filing Federal income tax returns on a fiscal-year basis must file their 1918 returns on a calendar-year basis (according to their accounting period) for the full calendar year, and compute the tax at 1918 rates. Credit will be allowed against such total tax for the proportionate part of the tax for the previous fiscal-year return applicable to 1918.

Section 212, Article 26: Change in accounting period. 11–19–370.
(Also Section 204, Article 1601.) T. B. R. 37.

Application for permission to render returns on the basis of calendar year, including a short return for the six months ending December 31, 1918, by a corporation heretofore reporting on the basis of the year ending June 30.

This is an application by the X Company for permission to change its return year as described in the headnote. Such permission is requested on the grounds that (1) the original change from a calendar year to the present fiscal year "was made at the suggestion of some one from the deputy collector's office" and "was not desired by the company, but acquiesced in by them in order to cooperate with the deputy collector;" (2) "the expense of preparing two sets of returns each year is excessive;" and (3) "the company will, in case such change is not authorized, be deprived of the privilege of deducting net losses under section 204 of the 1918 Act."

The first two grounds stated above were not stressed in the appeal and do not deserve extended consideration. Whether the change in the return year was originally made at the request of the department or not, the company would have been compelled by the Revenue Act of 1918 to report on the basis of 12 months ending June 30, 1918; and so far as the expense of preparing two sets of returns each year is concerned, this would be necessary at least for the first year if the application were granted—i. e., a special report would have to be prepared for the six months ending December 31, 1918; and if the present fiscal year is retained, two sets of returns thereafter will not be necessary unless the rate of taxation be changed. The only real argument for the change presented to the Advisory Tax Board is that it is necessary to place the company in a position to take advantage of the provisions of section 204.

Section 212 (b) of the Revenue Act of 1918 provides that:

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer: * * * If a taxpayer changes his accounting period * * * the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

This language supplies the statutory principle governing changes of the return year. The first object of the statute is to place the return on the basis of the accounting period normally or regularly employed by the taxpayer; and thereafter, if the taxpayer changes his accounting period, the net income shall, provided the Commissioner approves, be computed on the basis of the new accounting period. The apparent intent of the statute is that the taxpayer shall adopt the accounting period which, in view of the seasonal and other characteristics of his business, is most serviceable in securing an exact measure of the annual net income. Changes in the return year are not lightly to be approved. They necessitate highly complicated adjustments of deductions, credits, and rates; they affect, sometimes profoundly, the invested capital and the amount of tax to be paid; they impose upon both the taxpayer and the department considerable labor and expense. Change in the return year should ordinarily (perhaps necessarily) be permitted only for sound business reasons following an actual change in the accounting period employed by the taxpayer for the purpose of closing his books and striking an annual balance of gain or loss. This we believe expresses the plain intent of the statute. If, however, the statute does not clearly enunciate such a rule, the above statement represents the policy or principle which in the opinion of the Advisory Tax Board should govern the Commissioner in the exercise of that wide discretion with which the statute in this connection invests him.

It is not necessary in this case to decide whether a taxpayer sustaining or plainly destined to sustain a net loss in the calendar year 1919 or in some 12 months period beginning after October 31, 1918, and ending before January 1, 1920, could be permitted to change his return year for the purpose of deducting such loss from an earned income for the taxable year 1918 and thus relieving a real hardship. No such case is here presented. Assuming that there will be a net loss for the 6 months ending June 30, 1919, this loss will in the return for the 12 months ending June 30, 1919, be absorbed by or charged against income earned during the 6 months ending December 31, 1918. In the more recent months the business of the company has improved. It is probable that there will be no loss for the last 6 months of the calendar year 1919. If, however, a loss is sustained, there will be opportunity to charge it against the normal profits which may be expected for the 6 months ending June 30, 1920. No special hardship, therefore, has arisen or is likely to arise in this case; and if it does it will be attributable to other events occurring before the signing of the armistice rather than to those possibly adverse commercial conditions of the postwar period which section 204, it may be admitted, was designed in part to soften or counteract.

In this case sufficient reason has not been given to depart from the general rule that a taxpayer once having returned upon the basis of the business year best adapted to reflect the true income should not be permitted to depart from that return year, that in the ordinary case change in the return year for the purpose of modifying the tax should be discouraged, and should be permitted only for sound business reasons *following* an accomplished change in the accounting period actually employed in keeping the books of the taxpayer.

It is therefore recommended that the application for permission to change the return year of the X Company be denied.

Section 212, Article 26: Change in accounting period. 1–19–19.
O. D. 10.

A taxpayer who, during 1918, has given notice according to the statute and regulations in effect at that time, of a change from a fiscal to a calendar-year basis for filing returns, may notwithstanding articles 25 and 26 of Regulations No. 45, file a return for the period from the close of his fiscal year to the end of the calendar year.

Section 212, Article 26: Change in accounting period. 10–19–355. O. D. 205.

For the purpose of giving notice of change in accounting period as prescribed in article 26, Regulations 45, "due date" means the original due date of the return and not the date on which the return should be filed in case an extension of time is granted.

Section 213 (a).—GROSS INCOME DEFINED: INCLUSIONS.

Section 213 (a), Article 31: What included in gross income. 1–19–21. S–957.

Money recovered as damages in libel proceedings is subject to income tax.

Section 213 (a), Article 31: What included in gross income. 12–19–398. T. B. R. 42.
(Also Section 201, Article 1541.)

A corporation in due course of business during the calendar year 1918 declared and paid a dividend the major portion of which was paid out of earnings of the calendar years 1914, 1915, and 1916. Both at the time of declaration and at the time of payment of such dividend the Revenue Act of 1916 as amended by the Revenue Act of 1917 (see sec. 31 (b)) was in force, which provided for the taxation of dividends "at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation." In the calendar year 1919, after the passage of the Revenue Act of 1918 which changed the method of taxing cash dividends so that they became taxable at current rates, the corporation took action purporting to rescind the declaration of the dividend, and the stockholders repaid the amounts received by them from the corporation. It is inferred from the statement of facts that the declaration and payment of the dividend were legal and that the corporation could not have required the stockholders to pay back the amounts received in distribution but that such repayments were made voluntarily. May the stockholders disregard the dividend and omit the amounts received by them in payment thereof from their returns for the calendar year 1918?

The rights of the stockholders with respect to the dividend became fixed at some time not later than the date of payment thereof. Such rights were not subject to any liability to repay amounts received. The dividend, therefore, became during the calendar year 1918 a part of the gross income of the stockholders. After it had acquired the character of gross income the stockholders could not by voluntary action on their part take away such character. The repayment of the dividend was a new and independent transaction. It is immaterial that neither the corporation nor the stockholders knew what effect the declaration and payment of the dividend would have upon tax liability. All business transactions carried on during the calendar year 1918 were carried on without exact knowledge as to the effect thereof upon tax liability, but the effect of such transactions can not be avoided on account of such lack of knowledge.

It is not claimed—nor can it be—that the repayment of dividends is allowable as a deduction from the gross income of the stockholders for either the calendar year 1918 or the calendar year 1919.

The case submitted is not one in which the corporation had a legal right to require repayment and the legal effect of rescission in such case upon stockholders' liability to tax need not now be considered.

It is held, therefore, that the rescission and voluntary repayment in the calendar year 1919 of a corporate dividend legally declared and paid in 1918 does not warrant the exclusion of such dividend from the gross income of the stockholders for the calendar year 1918.

Section 213 (a), Article 31: What included in gross income. 25–19–581. A. R. M. 1.

A, upon becoming an officer of the M Company, invested in the capital stock of the company at par and later purchased additional shares. It appears that at the time of purchase of this stock it was agreed, and so provided by the by-laws of the company, that should any employee holding common stock sever connection with the company, such employee should sell to the company all the common stock so held, receiving therefor its book value. In 1918 A severed his connection with the M Company, and under the terms of his agreement surrendered his stock, receiving book value therefor, such book value being x dollars in excess of the amount paid therefor. A protests against taxation of this profit on the ground that the sale was not voluntary.

This Committee is of the opinion that this protest is without merit, since there is no warrant of law for exempting profits actually realized from tax because such realization is involuntary, and it therefore recommends that the decision of the unit as to the taxability of the profit made be approved.

Section 213 (a), Article 31: What included in gross income. 1–19–23. O. D. 11.

A person in the service of the American Red Cross receiving maintenance but no pay should return as income any excess of the amount received for maintenance over his actual living expenses.

Section 213 (a), Article 31: What included in gross income. 1–19–24. O. D. 12.

Compensation of teachers of the Territory of Hawaii is subject to income tax under section 213(a).

Section 213 (a), Article 31: What included in gross income. 1–19–25. O. D. 13.

Profit on goods sold by a consignee is income to the consignor for the year in which the sales are made, even though the consignor received no notification of sale until a subsequent year. If reported otherwise, amended returns should be filed.

Section 213 (a), Article 31: What included in gross income. 1–19–26. O. D. 14.

If a taxpayer receives through mistake an amount in payment of a contract in excess of the amount agreed upon in the contract, the excess is not taxable income. It is in the nature of a liability to the party with whom the contract was made.

Section 213 (a), Article 31: What included in gross income. 1–19–28. O. D. 16.

Interest received by a bank on loans to subscribers for Liberty bonds is *not* interest received on obligations of the United States, and is therefore subject to tax.

Section 213 (a), Article 31: What included in gross income. 1–19–31. O. D. 19.

Commissions advanced in payment for services of an advertising solicitor should be reported as gross income for the taxable year in which received. Any portion of the commissions thus received, which are paid back, owing to failure of payment for advertising, may be deducted as a loss for the year in which payments are returned. (Also sec. 214.)

Section 213 (a), Article 31: What included in gross income. 1–19–32. O. D. 20.

The term "State" as used in the income tax laws refers only to the States composing the United States. Therefore, income derived by an American citizen from a foreign Government is not exempt from tax and should be included in his return of annual net income.

Section 213 (a), Article 31: What included in gross income. 1–19–33. O. D. 21.

Income received by an individual or corporation due to selling War Savings Stamps at the appreciated value should be reported as income for the year in which the sales were consummated.

Section 213 (a), Article 31: What included in gross income. 1–19–38. O. D. 26.

(Also Section 214 (a) 1, Article 101.)

The amount which a plaintiff should report as income or a defendant may deduct as an expense in the case of an award for damages on account of patent infringement is not affected by the amount of Federal taxes which have been paid by the defendant. The amount to be reported or deducted is the total amount awarded by the courts.

Section 213 (a), Article 31: What included in gross income. 9–19–338. O. D. 195.

(Also Section 213 (b), Article 85.)

Held that a witness summoned by a State attorney to give testimony is not an employee of the State. Fees received by such witness are therefore subject to taxation.

Section 213 (a), Article 31: What included in gross income. **13–19–416.** O. D. 238.

The difference between the face value at maturity and the purchase price of noninterest-bearing warrants issued by a subdivision of a State and purchased at a discount is discount rather than interest and is subject to tax.

Section 213 (a), Article 31: What included in gross income.

(See 8–19–331; sec. 233, art. 541.) Taxability of interest received by banks on loans made to customers on account of Liberty bonds purchased for them.

Section 213 (a), Article 31: What included in gross income.

(See 10–19–360; sec. 225, art. 421.) Income from trust received by beneficiary who is also trustee.

Section 213 (a), Article 31: What included in gross income.

(See 11–19–376; sec. 213 (b), art. 86.) Taxability of compensation received by a person in military service from the Spruce Division.

Section 213 (a), Article 31: What included in gross income.

(See 20–19–502; sec. 201, art. 1541.) Dividends illegally declared and later repaid to the corporation.

Section 213 (a), Article 31: What included in gross income.

(See 21–19–520; sec. 201, art. 1541.) Tax liability of domestic corporation under Revenue Act of 1917 on dividends received from a foreign corporation having no income from sources within the United States.

Section 213 (a), Article 32: Compensation for personal services. 3–19–178. **T. B. R. 12.**

> Where the compensation of a receiver, trustee, or similar fiduciary, is awarded or paid at the conclusion of the trust, it is presumed, in the absence of satisfactory evidence to the contrary, that it did not accrue during the course of the trust, and it is accordingly taxable as income of the year when awarded or paid.
>
> Where it is understood at the beginning of the trust that the amount of the compensation is not to be determined until its conclusion, and this understanding is adhered to during the course of the trust and no payments are made on account of such compensation, this presumption becomes conclusive.

A was appointed receiver and later the court ordered that he and his co-receiver should each be paid x dollars per month, and " that on being discharged from their trust " each should " be at liberty to apply for such further compensation as to the court may then appear reasonable and just." A's co-receiver resigned and thereafter A acted as the sole receiver until 1918, at which time he resigned. On that date the court also ordered and decreed that A was entitled to additional compensation. It is with respect to this additional compensation that the question as to the rates at which it is to be taxed arises.

While the matter was pending before the Bureau of Internal Revenue, the court, upon A's petition, entered a further order *nunc pro tunc* to the effect that A's services were rendered continuously and the compensation earned and accrued ratably during the period of the receivership.

This apportionment was reached by prorating according to the portion of the entire period of the receivership falling in each calendar year, and it is claimed that the same apportionment should be made for purposes of the income tax, and that the rates of tax in effect in each of such years should be applied to the several portions respectively.

The gist of the argument made in behalf of the taxpayer was that under the acts in effect in the several years covering the period of the receivership, an individual taxpayer could report his income for tax purposes upon an accrual basis; that a certain definite amount was earned and accrued during each of those years—that it was impossible for the taxpayer to report these earnings in the return when made for each year, which would, of course, in view of the present high taxes, have been a decided advantage to him; and that because it was so impossible he should not be denied the benefits of the lower rates of taxation which would otherwise have applied to the income of those years.

It is doubtful and probably incorrect to say that the taxpayer could have reported his net income upon the accrual basis. The Revenue Act of 1916 taxes "net income * * * received" (section 8 (*a*)) and authorizes reports upon another basis only in the following case:

(*g*) An individual keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect his income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make his return upon the basis upon which his accounts are kept, in which case the tax shall be computed upon his income as so returned.

It appears that this particular taxpayer never did in the past definitely elect to report upon an accrual basis. It was also stated at the hearing that he kept no definite books of account and that the returns were made up by his secretary from such data as his check book, and that there was never a conscious use of either the cash receipts method or the accrual method. In a word, his returns were made up primarily on a cash receipts basis, and as not keeping the books necessary to warrant or sanction a return on the accrual basis, he was under the law and regulations compelled to make return on the cash basis.

Whether or not a taxpayer who did not in the past report upon an accrual basis can, at a subsequent date when circumstances make it apparent that such would have been the more beneficial course, amend his returns so as to place them upon that basis is open to serious question. It is not, however, necessary to decide at this time whether such a change in the method of making returns can ever be permitted at a subsequent period, inasmuch as the board is of the opinion that in this and most similar cases the contention made in behalf of the taxpayer must be denied in any event upon an entirely different ground, namely, that the additional compensation in question was of such a nature that it could not have properly been accrued, even though the taxpayer had been making his returns upon an accrual basis.

In the brief presented in behalf of the taxpayer it is admitted that it was impossible for the taxpayer prior to 1918 to ascertain the amount he was earning and to account therefor in his income-tax returns, and it is intimated in at least one place that this was due to the fact that "the court failed and declined to fix the amount which accrued until 1918," and the question is asked "Why should he be subjected to a loss because of the inaction of the court which was beyond his control?" The answer to this question suggests the answer to the larger question upon which the case turns. There was no failure or inaction on the part of the court; but, on the other hand, as is more or less common in this class of cases it was not practicable for the court to find definitely that any additional compensation had been earned or accrued prior to the conclusion of the receivership. It must be presumed in the absence of more definite evidence to the contrary that the amount awarded and paid per month during the course of the receivership was in the nature of a minimum compensation for time and effort, and that any additional amount was more in the nature of compensation for the successful conduct of the receivership as a whole and could not be said to have accrued until the receivership had been brought to a satisfactory conclusion or the receiver's connection with it had terminated under satisfactory conditions. If the continued success of the receivership was in whole or part a necessary condition to the receiver's becoming entitled to additional compensation, and if a failure on his part might result in the loss to him of any contingent right which he might have had to the payment of all or any part of the additional amount which was finally awarded, it can not be that any amount in excess of the minimum which was assured to him and which was actually paid can be held to have accrued from year to year during the course of the receivership. In a word, if it was impracticable for the court to decree at any time prior to the termination of the taxpayer's services as receiver that additional compensation had been earned or accrued, it results, therefore, that it is impossible to hold that such additional compensation could have accrued for purposes of income taxation.

In the argument made in behalf of the taxpayer it is claimed that this is not the usual case of a lump sum paid for services rendered over a period of years where it is impossible to clearly define and state how much was earned each year, and that it is not a case of an ordinary fee of a lawyer or a receiver or a trustee or a broker or an executive collected in one year for services rendered over a period of years. This argument is based on the fact that the court has found and adjudged exactly what portion of the entire amount was earned and accrued in each year. The Board is not of the opinion that there is any substantial distinction between the cases. The court, it is true, has prorated the compensation ultimately awarded and has found that it "was earned and accrued" at the amounts already stated for the several years. But this case was not before the court and the mere use of the word "accrued" in the decree can not properly be regarded as determining the question that such income "accrued" for purposes of Federal income tax. Compensation eventually paid after the conclusion of the receivership, in accordance with both the letter and the spirit of the original order which provided that on being discharged from his trust the receiver might apply for such further compensation as might then appear just and reasonable, can not be held to have accrued during the period of the receivership. The fact that the court declined, although the taxpayer several times requested it to do so, to make any additional award during the course of the receivership, is far stronger evidence that during the receivership it did not consider additional compensation to have accrued, than is its finding seemingly to the contrary effect but made after the matter had been closed.

It is, therefore, recommended that the past practice of the Bureau be adhered to, and that in this case the additional compensation received in 1918 be subjected to taxation at the rates in effect for that year.

Section 213 (a), Article 32: Compensation for personal services. 1–19–27. O. D. 15.

Compensation received by Federal reserve agents and their assistants, as well as other employees of Federal reserve banks, is subject to the income tax.

Section 213 (a), Article 33: Compensation paid other than in cash. 18–19–475. O. D. 265.

Board and lodging furnished seamen in addition to their cash compensation is held to be supplied for the convenience of the employer and the value thereof is not required to be reported in such employees' income tax returns.

Section 213 (a), Article 35: Gross income from business.

(See 28–19–610; sec. 203, art. 1583.) Treatment of cash discounts on purchases in connection with valuation of inventories.

Section 213 (a), Article 38: Gross income of farmers. 18–19–476. O. D. 266.

The use of Form 1040 F is optional since it is designed merely to assist farmers in computing their net income. Therefore, it is unnecessary to file same where the taxpayer has made return and paid the taxes due.

Section 213 (a), Article 38: Gross income of farmers.

(See 6–19–268; sec. 212, art. 23.) Returns and inventories of farmers when books of account are on an accrual basis.

Section 213 (a), Article 39: Sale of stock and rights. 19–19–495. T. B. M. 73.

Revenue Act of 1916.—The entire amount received from the sale of rights to subscribe for stock is income.

In the year 1916 the taxpayer owned shares of stock in a bank. In that year the bank voted to increase its capital stock by issuing additional stock to its stockholders at par, share for share according to their holdings. In the same year the taxpayer sold his rights to subscribe for new stock. The Income Tax Unit ruled that the entire amount received for the rights should be included in the gross income of the taxpayer for the year 1916 and the taxpayer appealed, claiming that the sale of rights constituted a realization of capital which should be credited against the market value of the original stock on March 1, 1913.

The Revenue Act of 1916, unamended, is here applicable. Under this act, as amended by the Revenue Act of 1917, which, so far as can be perceived, makes no change in the law with respect to this case, a regulation was adopted holding that if rights to subscribe for stock are sold "the proceeds of such sale are in their entirety income for the year in which the rights are sold." (Regulations 33 (revised), art. 95. See also art. 4, par. 61.) These regulations state the rule which was followed under the Revenue Act of 1913. They were reexamined and approved December 10, 1918, and were incorporated in Regulations 45, article 39, applicable to the Revenue Act of 1918 in the following terms:

> The entire amount realized from the sale of rights to subscribe for stock is income.

This conclusion has the support of a decision of the Supreme Judicial Court of Massachusetts with reference to the income-tax law of that State. (Trefry *v.* Putnam, 227 Mass., 522.)

There are three possible views as to the treatment for purposes of income taxation of rights to subscribe for stock: (1) That such rights are income when issued; (2) that the proceeds of the sale of such rights are income at the time of sale; (3) that the proceeds of a sale of rights are a return of capital to the stockholder and are taxable only if and to the extent that they exceed in amount the cost, or market value on March 1, 1913, of the stock upon which they were issued. As above indicated, the second position has been consistently held by the bureau, though strong arguments can be advanced for each of the other views. The Advisory Tax Board is of opinion, however, in line with Solicitor's Memorandum, S–676, that the position consistently and with due consideration held by the bureau, which is reasonably favorable to the Government and is not unfair to the taxpayer, and which is supported by the only decided case which has come to the attention of the bureau, should not be abandoned unless and until the decisions of the courts can furnish some indication that another view is correct.

The taxpayer acquiesces in the principle of the regulation as applied to a case in which stock originally held by the stockholder is not diminished in value by the issuing of the rights but contends that where the original stock is diminished in value the proceeds of a sale of rights should be treated as a return of capital. In respect to the effect upon the value of the original stock the issuance of rights to subscribe for new stock is analogous to the payment of a cash dividend. In Lynch *v.* Hornby (247 U. S., 339, 346) the court held that notwithstanding the fact that the payment of a cash dividend ordinarily "diminishes by just so much the assets of the corporation, and in a theoretical sense reduces the intrinsic value of the stock," the entire amount of such dividend constituted income. The Advisory

Tax Board is of opinion that this analogy should be followed and no distinction should be taken between a case in which the issue of rights diminishes the value of the stock and a case in which it does not.

From the above consideration it follows that the entire sum received by the taxpayer as the proceeds of the sale of rights to subscribe for stock should be included in his gross income for the taxable year 1916.

Section 213 (a), Article 41: Sale of good will. 1–19–22. O–791.

In determining the value of a corporation's assets, including good will, as at March 1, 1913, contemporary sales of stock are held to be of greater weight than values based on appraisal.

Section 213 (a), Article 42: Sale of personal property on installment plan. 8–19–313. T. B. R. 24.

A taxpayer engaged in merchandizing upon the installment plan who has heretofore made returns upon the basis of treating the profit upon installment sales as realized at the date of sale and now wishes to change to the basis of reporting the profit as being realized at the date of collection of the outstanding accounts should prepare and file as part of his return an amended balance sheet as at the date of the beginning of the taxable year, in which there shall be excluded from the surplus the unrealized gross profits upon the outstanding installment sales contracts at that date. Such amended balance sheet would be in substantially the following form:

Balance sheet as at opening of fiscal year.

ASSETS.

Plant and equipment	$----------	
Less depreciation	----------	
		$----------
Current assets:		
Merchandise as per inventory	----------	
Installment sales contracts	----------	
Notes receivable	----------	
Accounts receivable	----------	
Cash	----------	

Deferred debit items:		
Insurance premiums paid in advance	----------	
Other items	----------	----------
Total assets		----------

LIABILITIES.

Capital stock (or individual's or partner's capital)		$----------
Mortgage indebtedness		----------
Current liabilities:		
Bills payable	$----------	
Accounts payable	----------	
Wages or other accrued items	----------	

Deferred credit items:		
Unrealized gross profits upon installment sales contracts	------------	
Surplus	------------	

Total liabilities		------------

(2) As from the beginning of the taxable year the following accounts should be set up:

(*a*) *Goods purchased*, which will be charged with the amount of inventory of the goods on hand at the beginning of the taxable year and with the expenditures for goods purchased during the year.

(*b*) *Goods sold* (cost value), which will be credited with the cost value of all goods sold during the year.

(*c*) *Installment sales contracts*, which will be charged with the amount of the outstanding installment sales contracts at the beginning of the year and with the amount of installment sales contracts made during the year. This account will be credited with all cash collected during the year upon installment sales contracts and with the unpaid installments of defaulted or canceled contracts.

(*d*) *Unrealized gross profits on installment sales contracts*, which will be credited with the amount of unrealized gross profit upon the outstanding installment sales contracts at the beginning of the year and with the amount of such unrealized gross profit upon installment sales contracts made during the year. This amount will be computed upon the basis of the total installment sales contracts reduced by the cost or inventory value of the goods covered by the contracts, the remaining balance being the amount of the unrealized gross profits.

(*e*) *Realized profits on installment sales contracts*, which will be credited from month to month, or at least at the end of the year, with the profits realized by collection upon installment sales contracts. Such profits should be computed by taking the same percentage of the total cash collections upon installment sales contracts during the period as the total unrealized profits on installment sales contracts bears to the total installment sales during the same year. Corresponding debits should be made to unrealized gross profits on installment sales contracts. Any necessary corrections to produce a more accurate result can be made as at the end of the fiscal year.

It is believed that sufficient has been said above to indicate the use that is to be made of these special accounts, and it is not necessary to discuss any of the other accounts which would normally be maintained.

It will be noted that the foregoing plan which will be permitted upon an explicit statement of facts made to the Commissioner of Internal Revenue by a taxpayer engaged in merchandising upon the installment plan is not a change from an accrual basis to a cash received and paid basis. In the opinion of this office the income of a merchandising concern can not be correctly reflected upon the latter basis, as the use of inventories is absolutely essential. The plan herein outlined is, therefore, merely a modification or adaptation of the ordinary accrual method of accounting as in the opinion of this office will enable the accounts of the taxpayer to clearly reflect his net income. Where in the past another method has been used that has failed to reflect the taxpayer's net income an amended return or returns for such year may be made.

Section 213 (a), Article 42: Sale of personal property on installment plan. 1–19–35. O. D. 23.

A corporation doing business on both a cash and installment basis should report profits on the installment sales on the basis outlined in Treasury Decision 2707 and article 42 of Regulations 45. The cash sales, each of which represents a completed and closed transaction, should be reported separately; that is, the entire profits derived from every cash sale must be reported as income in the return for the year in which the sale was made.

Section 213 (a), Article 42: Sale of personal property on installment plan. 1–19–36. O. D. 24.

A corporation which has heretofore been treating all installment sales as completed transactions and desires to change its method to that of treating as deferred profit the amount of profit on unpaid installment sales standing on its books December 31, 1918, is permitted to change; but this office will not approve a change merely because the taxpayer will derive an advantage from decreased tax liability. When a change is approved the taxpayer will be required to adhere to it in his returns for subsequent years, and the first return made under the changed method should be accompanied by a letter of explanation; C. O. D. and "will-call" sales should be included in the inventory at the close of the year if the merchandise has not actually been shipped to the customers, unless such merchandise has been included in sales of the taxable year, in which case it should be excluded from inventory.

Section 213 (a), Article 42: Sale of personal property on installment plan. 1–19–37. O. D. 25.

If books have been so kept that the cost of each article sold was not shown, gross profit may be determined by taking the average percentage of gross profit on gross sales. If several different lines of merchandise are handled, on which the average percentages of profit differ, the gross profit on total sales of each different class of merchandise should be computed separately.

Section 213 (a), Article 42: Sale of personal property on installment plan. 4–19–212. O. D. 134.

If a stockholder of a corporation sells stock to employees of the company for consideration of 10 per cent cash and the balance in installment payments, secured by notes covering a period of 10 years, that proportion of each installment payment received during the taxable year which the gross profit to be realized bears to the gross contract price should be reported as income for the year during which installment payments were received.

Section 213 (a), Article 42: Sale of personal property on installment plan. 23–19–542. O. D. 290.

Where the stockholders of a corporation sell their shares in the corporation for a price in excess of cost and receive a cash payment not in excess of 20 per cent of the total price, the purchasers agreeing to pay the balance in a number of semiannual installments and deposit collateral with trustees as security for the faithful performance of the contract, the transaction is not an installment sale within the meaning of article 42, Regulations 45. The entire consideration involved in the sale must be treated as the equivalent of cash in the year when the sale is consummated.

Section 213 (a), Article 43: Sale of real estate in lots. 12–19–399.
O. D. 226.

Where building lots contained in a given tract of land are sold before the contemplated development work is completed, the profit realized should be determined on the basis of the cost of the land, or its fair market value on March 1, 1913, if acquired prior to that date, plus actual and estimated future expenditures for the development of the property in accordance with the contract of sale.

Section 213 (a), Article 44: Sale of real estate involving deferred payments. 8–19–314.
O. D. 181.

In the case of real estate sales involving deferred payments, even though substantial first payment is made, if the notes given by buyers of real estate can not be discounted nor sold on account of lack of credit of the buyers, such notes need not be regarded as the equivalent of cash, and the vendors may report as their income from the proposed transaction for each year only the proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price.

Section 213 (a), Article 47: Annuities and insurance policies. 7–19–289.
O. D. 170.

An individual who receives income from an annuity which has been purchased for his benefit by another person is not liable for tax thereon until the payments received under the terms of the annuity have equaled the amount paid or set aside to purchase or establish same.

Section 213 (a), Article 49: Compensation for loss. 15–19–443.
(Also Article 50.) T. B. M. 61.

> The replacement of one vessel by another of somewhat greater capacity is, within the meaning of article 49 of Regulations 45, a replacement in kind; permission to maintain a replacement fund for one year with the privilege of asking for a further extension of time is reasonable.

Advice has been requested (1) as to whether the X Company is entitled to set up a replacement fund and to claim that the replacement of a steamer by one of greater dead-weight tonnage is a replacement in kind, and (2) whether a replacement at any time within the three-year plan of the Shipping Board may be considered a replacement within a reasonable time.

The X Company owned a steamship which was sunk by an enemy action. Compensation for this loss was awarded the owners by the Bureau of War Risk Insurance, and the company is, therefore, clearly entitled to set up a replacement fund in respect of the sum so received. It now proposes to replace the loss of the steamer by the purchase of another steamship, which is a new vessel of greater dead-weight tonnage, and which, except as to size, appears to be the same general type of steamer as the one sunk. It is always difficult to replace such an article as a steamship by another which closely corresponds in every particular. Unless the new vessel is built to specifications there are almost certain to be variations of one sort or another, and the decision as to whether the new vessel effects a replacement in kind ought to be made along reasonably broad lines. If the taxpayer elects to replace by a somewhat larger or somewhat smaller boat, so long as the general type of boat is the same as the one lost or destroyed, it may fairly be taken as a replacement in kind in so far as it equals the tonnage of the original vessel. In this case there should be charged against the replacement fund only such portion of the cost of the new steamer as would fairly represent the cost of a boat of the carrying capacity of the old steamer, proper allowance being, of course, made for any accrued depreciation upon the latter.

There is at the present moment much uncertainty as to the future of the shipping industry, and this factor may properly be taken into consideration in determining what is a reasonable period within which the replacement must be effected. The taxpayer desires permission to maintain its replacement fund for a three-year period. The Unit has recommended that the taxpayer be allowed to maintain the replacement fund for a period of one year with permission to submit, at the end of that time, to the Commissioner, a statement of the then existing conditions with a request for an extension. The proposal of the Income Tax Unit appears to be reasonable and should be adopted.

Section 213 (a), Article 50: Replacement fund for loss. 20–19–504.
(Also Article 49.) O. 914.

Where the owner of a requisitioned tug uses the proceeds to buy barges, this is not such a replacement in kind as to come within the provisions of articles 49 and 50 of Regulations 45.

The attached letter raises a question relative to the provisions of articles 49 and 50 of Regulations 45, whereby taxpayers whose property has been requisitioned by the Government are required to return as taxable income only that part of the amount received which is in excess of the sum actually and reasonably expended to replace the property substantially in kind. Where it is not practicable to restore the property immediately, the taxpayer is allowed to set up a replacement fund and to postpone replacement for a reasonable length of time.

The facts of the case are that a seagoing tug, carried on the owner's books at a valuation of x dollars, was requisitioned by the Government and $5x$ dollars paid for it. The owner of the vessel might, it is asserted, have readily sold it for $6x$ dollars. The company endeavored to replace the vessel, but found difficulty in so doing. Shortly after the vessel was requisitioned, the company lost two barges by marine casualty. The two barges aggregated $5y$ tons. The insurance recovered was x dollars. A barge of only y tons would, it is stated, now cost x dollars, so that the approximate situation of the company with respect to the barges is that it lost $5y$ tons on which the insurance was sufficient to cover y tons, leaving $4y$ tons to be otherwise replaced. The new barge which is being built has a capacity of $8y$ tons. The cost will exceed $4x$ dollars. The company desires permission to treat the barge as a replacement in part, and substantially in kind, of a tug, and thereby avoid payment of tax on such portion of the cash profit realized by the sale of the tug.

Articles 49 and 50 of Regulations 45 provide that where the owner of property has lost or transferred title by reason of the exercise of the power of requisition or eminent domain (including cases where a voluntary transfer or conveyance is induced by such proceedings), the owner by replacing the new or restored property in kind may avoid treating the loss of title by requisition as a closed transaction.

The replacement proposed in this case substitutes certain barges in the place of the tug which was lost. This is not a replacement in kind and is not strictly within the provisions of the regulations. After careful study of the act the conclusion is reached that the Commissioner would not be warranted in extending to this taypayer the relief which has been asked.

Section 213 (a), Article 50: Replacement fund for loss. 12–19–400.
T. B. R. 41.

In 1917 two steamers owned and operated by the X Company were requisitioned by the United States Shipping Board and turned over to the Navy Department.

In 1919 the Navy Department redelivered the ships to the Shipping Board and, in lieu of restoration, a sum of money was paid the Shipping Board by the Navy Department.

The two ships and the money received by the Shipping Board for purpose of restoration will be restored to the owner.

In view of the age of the vessels and the extensive repairs that must be made in case the old ships are restored, the owner now desires to know whether he may sell the vessels in their present condition and place the proceeds of the sale, together with the amount received for restoration, in a replacement fund to be used in the purchase of new ships, the new ships, when acquired, to be used in the same service as the old vessels before they were requisitioned by the Shipping Board.

In view of the circumstances above stated, the Advisory Tax Board recommends that the X Company be permitted to establish a replacement fund. The property proposed to be returned by the Government to the taxpayer is substantially different from the property taken from the taxpayer, and to be made usable would require the expenditure of a substantial amount. If instead of restoring the property the taxpayer elects to replace it, such right of election comes within the reasonable interpretation of articles 49 and 50, of Regulations 45. The compensation received will thereupon consist of the cash received from the Government plus the proceeds received from the sale of the unusable property, and the replacement fund should be established for this sum.

Section 213 (a), Article 52: When included in gross income. 2–19–141. S. 971.
(Also Section 201, Article 1548.)

Money and other property received in 1916 by a stockholder in the distribution of the capital and surplus of a corporation in process of dissolution of value in excess of the price paid by him for his stock (or of its fair market value on Mar. 1, 1913, if he acquired it before that date) is income to the stockholder for the year 1916.

Opinion is requested upon the question for what year certain money and property received as income by A in the distribution of capital and surplus of the X Company upon dissolution should be returned as income.

The facts are that A owned stock in the X Company, a corporation which in 1915 voted to dissolve. The method resolved upon to effect the dissolution was that the company holdings in excess of its liabilities be distributed among the stockholders of the company who at the close of business December 31, 1915, were ascertained to be stockholders of record. The transfer books were closed December 31, 1915, in order to determine the stockholders of record. The stockholders were given the option of taking as part of the capital and surplus so distributed either cash or stock in another company. No distribution of assets was made until January, 1916. In February, 1916, it was discovered that not all the assets had been distributed, there being cash and other property on hand. A meeting was held on that date and a resolution was passed ordering the property sold for cash or otherwise converted into assets easily distributable. In April, 1916, final distribution was made and the corporation fully dissolved.

The pertinent portions of the Act of September 8, 1916, read as follows:

"SEC. 1 (a). That there shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of 2 per cent upon such income * * *."

"SEC. 8 (a). The tax shall be computed upon the net income as thus ascertained of each person subject thereto received in each preceding calendar year ending December 31."

By the terms of the Revenue Act of 1916 the net income received in 1916 is subject to the tax imposed by that Act. As the income in question was all received in 1916 it was income for 1916 within the meaning of the Act.

It is held that money and other property received in 1916 by a stockholder in the distribution of the capital and surplus of a corporation in process of dissolution, of value in excess of the price paid by him for his stock (or of its fair market value on March 1, 1913, if he acquired it before that date) is income to the stockholder for the year 1916.

Section 213 (a), Article 52: When included in gross income. 2–19–140. O. D. 97.
(Also Section 201, Article 1541.)

The date of payment rather than date of receipt is the governing factor in determining when a dividend should be treated as taxable income to the recipient. Consequently, a dividend paid in Kansas and received there by stockholders December 30, 1917, but not received by stockholders in California until January, 1918, will be taxable at 1917 rates to the California stockholders.

Section 213 (a), Article 52: When included in gross income. 21–19–523. O. D. 282.
(Also Section 233, Article 541.)

When property is sold by individuals who are under agreement to incorporate at a later date, the proceeds of the sale being placed on deposit in a bank in escrow under the condition that the sale must be ratified by the directors of the corporation when organized, income accrues to the corporation at the time when the sale is ratified and the funds in escrow are made available to the company.

Section 213 (a), Article 52: When included in gross income. 30–19–635. O. D. 343.
(Also Section 201, Article 1548.)

Where the assets of a corporation in process of liquidation are being disposed of, the proceeds being distributed to the stockholders in installments, and it is not known what the total proceeds will be, and consequently the amount of profit to the stockholders can not be definitely determined, a stockholder should return no portion of the installment payments as income until the amount actually received exceeds the cost of the stock to him, or its fair market value as at March 1, 1913, if acquired prior to that date. However, if the corporation enters into a contract for the sale of its assets at a stipulated price, the purchaser making payment in installments, the portion of each liquidating payment to the stockholder representing profit is determinable and should be returned as income for the year during which received.

Section 213 (a), Article 52: When included in gross income.

(See 1–19–18; sec. 212, art. 22.) Profit and loss adjustments for prior years, made during the taxable year under instructions from the Interstate Commerce Commission.

Section 213 (a), Article 54: Examples of constructive receipt. 20–19–505. O–912.
(Also Section 218, Article 322.)

The donation by assignment of partnership profits to be earned in the future does not exempt such profits, when determined, from taxation as a part of the individual income of the donor.

Section 212 (a), act of February 24, 1919, provides that in the case of individuals the term "net income" means "gross income" less certain deductions.

Section 213 defines gross income as follows:

That for the purposes of this title * * * the term "gross income" (*a*) includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer * * *.

A is a member of a partnership with offices in Y and Z. Each partner's distributive share of the firm profits for the fiscal year is determined at the Z office. Until such a determination each partner has but a right to receive profits at a future time. It has been the practice of A to write the firm in Z each year directing it to set aside a certain percentage of his profits, when determined, for certain charitable purposes. Accordingly, when the firm makes distribution of profits there is placed on the firm's books to the credit of A only such shares as he retained the right to receive. The remainder of the profits properly accruing to him is credited and paid directly to the institutions designated by A as beneficiaries.

The question raised is whether the shares thus set aside are returnable as a part of the individual income of A and taxable as such.

Though a gift is exempt from taxation in the hands of the donee, section 213 (b) (3), that fact is obviously not controlling in determining its taxability as income when passing through the hands of the donor. It may very well be income to the donor though not to the donee, and the instant case is a typical one.

The taxpayer here directs his partners, who owe or will owe him money to the extent of his share of the profits, to pay a part of those profits to a third person, the donee named in the assignment. It is none the less the income of the taxpayer.

While the amount named in the assignment is never actually received by the donor, because of his ordering it to be paid to another, he admits his right of ownership by the very act of executing the assignment. The mere fact that it is received by his nominee, rather than by him, does not prevent its being his income.

Profits need not be reduced to actual possession in order that they shall be treated as income for tax purposes. (Reg. 45, art. 54.)

Section 218 (a) of the act provides in part:

That there shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year * * *.

This provision clearly requires that the individual return of each partner shall include his entire share of the partnership profits. That some one, not a member of the partnership, collects a portion of a partner's distributive share directly from the firm does not remove that requirement.

It is therefore held that where a taxpayer, in order to make a gift, directs one owing him money to pay the amount to a third person, such amount must none the less be returned as income by the donor.

Section 213 (b).—GROSS INCOME DEFINED; EXCLUSIONS.

Section 213 (b), Article 71: What excluded from gross income. 1–19–48. O. D. 36.

Money received by naval attachés to be expended by them for entertaining and exceptional purposes caused by reason of their duties is not subject to tax and need not be included in any income tax return such officers may be required to render, if expended solely in connection with their official duties and no part of same is diverted for personal use or expenses.

Section 213 (b), Article 71: What excluded from gross income. 3-19-180. O.D. 119.

A clergyman is not liable for any income tax on the amount received by him during the year from the parish of which he is in charge, provided that he turns over to the religious order of which he is a member, all the money received in excess of his actual living expenses, on account of the vow of poverty which he has taken.

Members of religious orders are subject to tax upon taxable income, if any, received by them individually, but are not subject to tax on income received by them merely as agents of the orders of which they are members.

Section 213 (b), Article 72: Proceeds of insurance. 6-19-270.
(Also Section 218 (a), Article 321.) T. B. R. 22.

Exemption of proceeds of life insurance policies paid on the death of the insured to partnership beneficiaries under the Revenue Act of 1916 and the Revenue Act of 1918.

Section 4 of the Revenue Act of 1916 provided that "the proceeds of life insurance policies paid to individual beneficiaries upon the death of the insured" should be exempt from income tax. Section 213 of the Revenue Act of 1918 provides, in part, that "proceeds of life insurance paid upon the death of the insured to individual beneficiaries, or to the estate of the insured" shall not be included in gross income. It will be noted that except as to estates this language is practically identical with that of the Revenue Act of 1916.

It is realized that this is not an easy question to decide, and that a mere textual construction of either act might justify a contrary decision; but in both acts a strong intent is disclosed to treat partnerships on the same general basis as individuals. For example, the individual members of a partnership are taxed under both acts on their distributive share of the earnings, whether distributed or not. The rates are not those applicable to the partnership as an entity, but are those applicable to each individual within the partnership group. These rates may vary widely among the members of the same partnership. Under the 1916 Act partnerships were allowed to deduct all the interest paid, while the similar deduction of corporations was limited.

In the ordinary case where the life of a member of the partnership is insured his death dissolves the partnership and the remaining partners receive the proceeds of the insurance policy as individuals. They would be compelled to sue in court as individuals. The distinction between such a case and an insurance policy payable to the partners as individuals is too small to warrant a difference in treatment. In the case of a corporation beneficiary there is an entity which is the beneficiary, which is separate and distinct from the stockholders, which can sue the insurance company in its own name, and which continues to exist after the death of the insured.

The unquestioned purpose of the paragraph in question was to grant the exemption to individuals and deny it to corporations. The place of the partnership is left in doubt. Taking into account all the factors which may properly be recognized as bearing upon this question, it is the opinion of the Advisory Tax Board that partnerships should be classed with individuals rather than corporations, and that Congress had no intention of treating partnerships differently in this respect under the two Acts in question. The fact that partnerships were subjected to an excess profits tax under the Revenue Act of 1917 can not be said to modify the meaning of this part of the Act of 1916. Under the 1916 Act partners were taxed only in their individual capacities, and the partnership did not file a return except on request by the Commissioner.

The Advisory Tax Board accordingly recommends that the phrase "individual beneficiary" used in the Revenue Acts of 1916 and 1918 be deemed to include a partnership beneficiary.

Section 213 (b), Article 73: Gifts and bequests. 7–19–290. S. 1022.

The Revenue Act of 1918, section 213 (b) (3) provides:

> That for the purposes of this title * * * the term "gross income" does not include * * * the value of property acquired by gift * * * (but the income from such property shall be included in gross income).

Regulations 45, article 1562, provides:

> In the case of property acquired by gift, * * * the basis for computing gain or loss on a sale is the fair market value or value of the property at the date of acquisition or as of March 1, 1913, if acquired prior thereto.

Not every case in which a gift is purported to be made is an actual case of gift. A mere colorable gift which leaves the donor still with the actual disposition of the property is not to be treated as a gift, even though there is delivery and all outward forms are complied with.

In the case of a real and actual gift of property which has appreciated in value between the time of acquisition and the time the gift is made, the appreciation will not be the subject of income taxation, and the donee who sells it will return as income only any appreciation realized over its value when the donee actually became the owner of it.

On the other hand, a mere colorable gift is not to be treated as a gift at all, and an attempt by such colorable gift to evade taxation is fraud for which either party who participates therein may be punished.

Section 213 (b), Article 73: Gifts and bequests. 22–19–533. O. D. 286.

A bonus paid by a State to its residents who served in the military or naval forces during the war with Germany does not constitute taxable income to the recipient.

Section 213 (b), Article 74: Interest upon State obligations. 1–19–42. O. D. 30.

Interest received on certificates of indebtedness known as "Fire relief certificates" issued in the State of Minnesota, is considered interest upon the obligations of a State and therefore not taxable.

Section 213 (b), Article 74: Interest upon State obligations. 28–19–611. O. D. 327.

Certificates of sale issued by a county or other political subdivision of a State in connection with the sale of property for nonpayment of taxes do not fall within that class of obligations of a State, county, or municipality, the income from which is exempt from Federal income tax.

Section 213 (b), Article 77: Interest upon United States obligations. 1–19–46. O. D. 34.

Interest on certificates of indebtedness issued by the Philippine Government is exempt from taxation, under the Revenue Act of 1918.

Section 213 (b), Article 77: Interest upon United States obligations. 3–19–181. O. D. 120.
(Also Section 214 (a) 11, Article 251.)

An owner of nontax-free Liberty bonds who has made an absolute gifts of the coupons attached to the bonds covering interest due for a number of years will be required to include in his income tax return the interest which accrues each year on the bonds, and to pay any tax that may be due thereon. If the gift of the coupons is to an institution under section 214(a) 11, a deduction of such gift would be allowed in the annual income tax return.

Section 213 (b), Article 77: Interest upon United States obligations. 10–19–356. O. D. 206.

Certificates of indebtedness issued by the Director General of Railroads are held to be obligations of the United States but not such obligations as are exempt from income, war profits and excess profits taxes.

Section 213 (b), Article 77: Interest upon United States obligations. 11–19–374. O. D. 212.

Interest upon bonds issued by the War Finance Corporation, the principal of which does not exceed $5,000 in aggregate, is exempt from taxation. (Section 16, Act approved April 5, 1918.) This exemption is in addition to the $5,000 exemption allowed under section 7, Act approved April 24, 1917, which amount includes Liberty bonds of any issue (excluding first), war savings certificates, and certificates of indebtedness.

Section 213 (b), Article 77: Interest upon United States obligations.

(See 1–19–116; sec. 325, art. 815.) Taxability of interest upon bonds of the War Finance Corporation.

Section 213 (b), Article 77: Interest upon United States obligations.

(See 8–19–331; sec. 233, art. 541.) Interest received by a bank from its customers on account of Liberty bonds carried for them.

Section 213 (b), Article 79: Liberty bond exemption from surtax and war profits and excess profits tax in 1918. 11–19–373. O. D. 211.
(Also Section 330, Article 933.)

If a partnership was an "original subscriber" to Liberty bonds of the fourth series and was reorganized as a corporation prior to July 1, 1919, and elects to be taxed as a corporation from January 1, 1918, in accordance with section 330, Revenue Act of 1918, the corporation will be considered an "original subscriber" to Liberty bonds of the fourth series within the meaning of article 79 of Regulations No. 45.

Section 213 (b), Article 79: Liberty bond exemption from surtax and war profits and excess profits tax in 1918. — 11–19–375. O. D. 213.

The words "the date of the tax return" as used in the supplement to the second Liberty loan act are held to mean the date on which the return is filed with the collector. Consequently a taxpayer holding the prescribed amount of fourth Liberty loan bonds on December 31, 1918, but who disposes of them on January 1, 1919, before his return has been filed is not allowed the exemption referred to in the supplement to the second Liberty loan act.

Section 213 (b), Article 80: Liberty bond exemption after December 31, 1918. — 2–19–148. T. D. 2836.

Liberty bonds and Victory notes issued under authority of the Acts of Congress approved April 24, 1917, September 24, 1917, April 4, 1918, July 9, 1918, September 24, 1918, and March 3, 1919, are entitled, respectively, to the exemptions from taxation set forth in said Acts, from which the statements on this page are summarized and to which they are subject.

I. The 4 and $4\frac{1}{4}$ per cent bonds are exempt from all Federal, State, and local taxation, except (*a*) estate or inheritance taxes and (*b*) Federal income surtaxes and profits taxes, as follows:

1. First Liberty loan converted 4 per cent bonds of 1932–1947 (First 4s).
2. First Liberty loan converted $4\frac{1}{4}$ per cent bonds of 1932–1947 (First $4\frac{1}{4}$s, issue of May 9, 1918).
3. First Liberty loan second converted $4\frac{1}{4}$ per cent bonds of 1932–1947 (First $4\frac{1}{4}$s, issue of Oct. 24, 1918).
4. Second Liberty loan 4 per cent bonds of 1927–1942 (Second 4s).
5. Second Liberty loan converted $4\frac{1}{4}$ per cent bonds of 1927–1942 (Second $4\frac{1}{4}$s).
6. Third Liberty loan $4\frac{1}{4}$ per cent bonds of 1928 (Third $4\frac{1}{4}$s.)
7. Fourth Liberty loan $4\frac{1}{4}$ per cent bonds of 1933–1938 (Fourth $4\frac{1}{4}$s).
8. Victory Liberty loan $4\frac{3}{4}$ per cent convertible gold notes of 1922–1923 ($4\frac{3}{4}$ per cent Victory notes.)

Are exempt, both as to principal and interest, from all taxation now or hereafter imposed by the United States, any State, or any of the possessions of the United States, or by any local taxing authority, except (*a*) estate or inheritance taxes and (*b*) graduated additional income taxes, commonly known as surtaxes, and excess profits and war profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, associations, or corporations.

II. The 4 per cent and $4\frac{1}{4}$ per cent bonds are entitled to limited exemptions from Federal income surtaxes and profits taxes, as follows:

4 per cent and $4\frac{1}{4}$ per cent Liberty bonds (but not $4\frac{3}{4}$ per cent Victory Notes) are entitled to certain limited exemptions from graduated additional income taxes, commonly known as surtaxes, and excess profits and war profits taxes, now or hereafter imposed by the United States, upon the income or profits of individuals, partnerships, associations, or corporations in respect to the interest on principal amounts thereof as follows:

$5,000 in the aggregate of First 4s, First $4\frac{1}{4}$s (issues of May 9 and October 24, 1918), Second 4s and $4\frac{1}{4}$s, Third $4\frac{1}{4}$s, Fourth $4\frac{1}{4}$s, Treasury Certificates, and War-Savings Certificates.

30,000 of First $4\frac{1}{4}$s (issue of October 24, 1918, only) until the expiration of two years after the termination of the war.

30,000 of Fourth $4\frac{1}{4}$s until the expiration of two years after the termination of the war.

30,000 in the aggregate of First 4s, First $4\frac{1}{4}$s (issues of May 9 and October 24, 1918), Second 4s and $4\frac{1}{4}$s, Third $4\frac{1}{4}$s, and Fourth $4\frac{1}{4}$s, as to the interest received on and after January 1, 1919, until the expiration of five years after the termination of the war.

45,000 in the aggregate of First 4s, First $4\frac{1}{4}$s (issue of May 9, 1918, only), Second 4s and $4\frac{1}{4}$s, and Third $4\frac{1}{4}$s, as to the interest received after January 1, 1918, until the expiration of two years after the termination of the war; this exemption conditional on original subscription to, and continued holding at the date of the tax return of, two-thirds as many bonds of the fourth Liberty loan.

20,000 in the aggregate of First 4s, First $4\frac{1}{4}$s (issues of May 9 and October 24, 1918), Second 4s and $4\frac{1}{4}$s, Third $4\frac{1}{4}$s, and Fourth $4\frac{1}{4}$s, as to the interest received on and after January 1, 1919; this exemption conditional upon original subscription to, and continued holding at the date of the tax return of, one-third as many notes of the Victory Liberty loan, and extending through the life of such notes of the Victory Liberty loan.

$160,000 total possible exemptions from Federal income surtaxes and profits taxes subject to conditions above summarized.

III. The $3\frac{1}{2}$ per cent bonds and $3\frac{3}{4}$ per cent notes are exempt from all Federal, State, and local taxation, except estate or inheritance taxes, as follows:

1. First Liberty loan $3\frac{1}{2}$ per cent bonds of 1932–1947. 2. Victory Liberty loan $3\frac{3}{4}$ per cent convertible Gold Notes of 1922-1923.	Are exempt, both as to principal and interest, from all taxation (except estate or inheritance taxes) now or hereafter imposed by the United States, any State, or any of the possessions of the United States, or by any local taxing authority.

Section 213 (b), Article 80: Liberty bond exemption after December 31, 1918. 6-19-272. T. D. 2865.

INTEREST ON VICTORY NOTES.

All interest accrued on 4¾ per cent Victory notes at the date of any conversion by the taxpayer into 3¾ per cent Victory notes will, for the purposes of computing net income, be deemed to be interest upon 4¾ per cent Victory notes, and will be entitled only to the exemptions from taxation to which interest on 4¾ per cent Victory notes is entitled. Any and all amounts received by any taxpaper from the United States by way of adjustment of accrued interest upon conversion of 4¾ per cent Victory notes into 3¾ per cent Victory notes will be deemed to be interest upon 4¾ per cent Victory notes.

All interest accrued on 3¾ per cent Victory notes at the date of any conversion by the taxpayer into 4¾ per cent Victory notes will, for the purposes of computing net income, be deemed to be interest upon 3¾ per cent Victory notes, and will be entitled to the exemptions from taxation to which interest on 3¾ per cent Victory notes is entitled.

Section 213 (b), Article 80: Liberty bond exemption after December 31, 1918. 2-19-171. T. B. R. 7.

Each of several affiliated corporations included in a consolidated return under section 240 of the Revenue Act of 1918 is entitled to the same full benefits under the exemption provisions of the several Liberty Bond Acts to which it would be entitled if not affiliated.

Advice is requested as to whether in the case of a consolidated return each affiliated company is entitled to the exemptions of interest provided in the various Liberty Bond Acts, or whether exemptions are based upon the consolidated condition.

First 3½ per cent unconverted bonds issued under section 1 of the First Liberty Bond Act of April 24, 1917, are exempt from all income and profits taxes and are as a result unaffected by the above ruling. Subsequent issues are, however, subject to the several provisions of section 7 of the Second Liberty Bond Act, approved September 24, 1917, subdivisions (1), (2), and (3) of the supplement to Second Liberty Bond Act approved September 24, 1918, and of subdivisions (a) and (b) of section 2 of the Victory Liberty Loan Act approved March 3, 1919. These provisions provide certain absolute, limited, or conditional exemptions of the interest on bonds "owned by any individual, partnership, association, or corporation," an expression repeated at least six times in the provisions just cited. In subdivision 2 of section 7 of the supplement to the Second Liberty Bond Act and in subdivision (b) of section 2 of the Victory Liberty Loan Act there are also certain conditions expressed in the following form:

Provided, That no owner of such bonds shall be entitled to such exemption

unless certain conditions are complied with.

It is evident that the provisions of the several bond acts, all except one of which were enacted prior to the enactment of the Revenue Act of 1918, contemplate that the test of the exemption to which a taxpayer is entitled is based entirely on his or its ownership of such bonds. The provisions creating the exemptions are found in the bond acts under which corporations are for all purposes considered as wholly separate entities. The requirement of a consolidated return is found only in the Revenue Act, and even there, as shown in the extract quoted later in this paragraph, when it is intended to allow only one credit, express provision is made to that effect. The agreement as to exemptions implied in statutes creating such exemptions can not either in justice or equity be deemed to have been modified by subsequent statutes in the absence of the most express provisions to that effect. There are absolutely no such provisions. Section 240 of the Revenue Act of 1918, approved February 24, 1919, provides as follows:

SEC. 240. (a) That corporations which are affiliated within the meaning of this section shall, under regulations to be prescribed by the Commissioner, with the approval of the Secretary, make a consolidated return of net income and invested capital for the purposes of this title and Title III, and the taxes thereunder shall be computed and determined upon the basis of such return: * * *

In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit of $2,000 (as provided in sec. 236); in computing the war-profits credit (as provided in sec. 311) only one specific exemption of $3,000; and in computing the excess-profits credit (as provided in sec. 312) only one specific exemption of $3,000.

The above provision requires a consolidated return in certain cases. It makes no reference to tax exemptions, and a consolidated or restricted tax exemption is neither demanded by its terms nor by the nature of a consolidated return. On the other hand, subscriptions to bonds of this sort are a matter not at all affected by the affiliated or independent status of a corporate subscriber.

It is accordingly held that the several provisions of the Liberty bond acts relating to exemptions apply separately to each corporation and that each of the several affiliated corporations included in a consolidated return be entitled to the same full benefits to which it would be entitled if not affiliated.

Section 213 (b), Article 80: Liberty bond exemption after December 31, 1918. 6–19–271. T. B. R. 28.

Status of banks as original subscribers to the fourth Liberty loan and Victory Liberty loan.

A question has arisen relative to the status of banks as original subscribers to bonds of the fourth Liberty loan and notes of the Victory Liberty loan in those cases where individual subscribers have agreed to take the bonds and have subsequently defaulted.

The Government encouraged individuals to subscribe for Liberty bonds and Victory notes through banks which it designated as "subscriber's agencies." The law gave certain exemptions to bond owners provided they were original subscribers and still owned the bonds. It seems clear that the bank and the individual can not both be the original subscriber to the same bonds, and that the status as original subscriber must be fixed at the time the subscription is made.

The following considerations seem to point irresistibly to the conclusion that the bank which takes over bonds after default by individual subscribers can not be considered an original subscriber.

In such cases the customer suffers the loss if the bonds fall in price, or realizes the gain if they advance in price. The bank gets the bonds for the market price and not for the issue price. The customer is legally bound to take the bond and is primarily liable to pay for it. The liability of the bank, if any, is secondary, and it is protected from any possibility of loss in all cases where a sufficient initial payment is required.

The department has ruled that the individual subscriber is the original subscriber and entitled to the exemptions even before the bonds are fully paid for, so long as he is not in default (Law Op. 673). If he defaults he loses the exemption not because he was not the original subscriber but because he is then no longer the owner of the bonds.

It would be highly undesirable to have the rights of either the bank or the individual subscribers depend upon variations in procedure. It is not believed that the result indicated above is changed by any of the following possible methods of buying the bonds:

(*a*) The bank may transmit the individual subscriptions to the Federal reserve bank or it may cover them with its own subscription, merely sending in the data necessary for making the proper allotments. Even in this latter case it must be held that the individual is an original subscriber. The bank is technically acting as an agent for the subscribers and the ownership of the bonds rests in the customer, even though his name is not disclosed to the Government.

(*b*) The bank in its contract with the customer may expressly reserve title until full payment is made. This is, however, a security title only, and the strict legal right of the bank is either to force the customer to take the bond or to sell the bond as collateral. If it chooses to keep the bond, probably the Government should not object, but the bank can not increase its rights as original subscriber by so doing.

(c) The bank may anticipate the customer's subscriptions and purchases. It is believed, however, that the entire subscription period should be considered as a whole, and that the anticipated purchase is more formal than real. The substance rather than the form of the transaction should be considered, and the result should not turn upon narrow questions of time, nor upon technical legal considerations as to whether the bank reserved a complete title or merely a lien or something in between these.

(*d*) In any case whether the bank pays the Government for the bonds in one cash payment or in installments is immaterial and the decision will be controlled by other facts in the particular case.

Section 213 (b), Article 80: Liberty bond exemption after December 31, 1918. 1–19–40. O. D. 28.
(Also Section 214 (a) 2, Article 121.)
(Also Section 325, Article 818.)

The computation of exempt interest from Liberty loan bonds will be based upon the full amount of bonds subscribed for and still owned. Interest upon obligations incurred to purchase or carry Liberty bonds issued after September 24, 1917, may be deducted from gross income.

In computing the amount of admissible assets for the purpose of determining the average percentage of inadmissible assets, the total cost of bonds subscribed for, whether fully paid for or not, may be included in admissible assets.

Section 213 (b), Article 80: Liberty bond exemption after December 31, 1918. 1–19–43. O. D. 31.

In cases where there have been a great many changes in the amount of Liberty bonds of the various classes, or other securities of the United States, held by a bank during the year, it will be permissible to determine the amount of interest derived from each class, in excess of the maximum exemption applicable from the books or other records of the bank. The correct amount of interest subject to tax, received or accrued, must be shown, and a statement attached to the return showing how the interest was determined.

Section 213 (b), Article 80: Liberty bond exemption after December 31, 1918. 12–19–401. O. D. 227.

Where a taxpayer has held at any time or times, within the taxable year Liberty loan bonds (any issues except the first unconverted), United States certificates of indebtedness, or war savings stamps, the total interest received being equal to or in excess of the interest for one year on an aggregate principal of $5,000, credit may be taken to an amount not exceeding such amount of interest for one year on the aggregate principal of $5,000.

Section 213 (b), Article 83: Income of foreign governments. 5–19–248. O. D. 153.

The provision which exempts from income tax certain income of foreign ambassadors, ministers, and their subordinates who were nonresident aliens at the time of appointment does not extend to income received by their wives from sources within the United States.

Section 213 (b), Article 83: Income of foreign governments. 8–19–315. O. D. 182.

Delegates to the United States representing a foreign country in connection with an agreement with the United States Food Administration, whereby flour is furnished to that country, and raw materials are brought to this country and sold, would not be subject to tax with respect to any profits derived from the sale of such products.

Section 213 (b), Article 83: Income of foreign governments. 9–19–339. O. D. 196.

Residents of the United States, as well as citizens thereof, are subject to tax with respect to any income received which represents compensation for services rendered to a foreign legation.

A subject of a foreign country, who at the time of his appointment to a legation in the United States, is a resident of the United States, would be subject to tax on the same basis as a citizen of the United States.

Section 213 (b), Article 83: Income of foreign governments. 29–19–624. O. D. 336.

Only foreign diplomats, ambassadors, and other diplomatic representatives in charge who are accredited to the United States to represent their sovereign or country and who reside here, and the members of their staff are entitled to exemption from tax on income from investments in bonds and stocks and from interest on bank balances. Foreign consuls resident in the United States are not entitled to the exemption.

Section 213 (b), Article 84: Income of States. 14–19–433.
(Also Section 219, Article 341.) O. 895.

PROPERTY GIVEN TO MUNICIPALITY IN TRUST.

Where property is willed to a municipality in trust that the income of the property shall be used for a public charity the income is not liable to Federal income tax and the trustees of the fund are not required to file annual tax returns.

Section 2 (b) of the Act of September 8, 1916, provides as follows:

Income received by estates of deceased persons during the period of administration or settlement of the estate shall be subject to the normal and additional tax and taxed to their estates, and also such income of estates or any kind of property held in trust including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust shall be likewise taxed, the tax in each instance, except when the income is returned for the purpose of the tax by the beneficiary, to be assessed to the executor, administrator, or trustee, as the case may be: *Provided*, That where the income is to be distributed annually or regularly between existing heirs or legatees, or beneficiaries, the rate of tax and method of computing the same shall be based in each case upon the amount of the individual share to be distributed.

Such trustees, executors, administrators, and other fiduciaries are hereby indemnified against the claims or demands of every beneficiary for all payments of taxes which they shall be required to make under the provisions of this title, and they shall have credit for the amount of such payments against the beneficiary or principal in any accounting which they make as such trustees or other fiduciaries.

This provision was not amended by the Act of October 3, 1917.

A provided in his last will and testament that a portion of his property be held in trust by the City of Y and that it constitute a fund to be used for certain charitable purposes. The legacy was accepted by the city.

The city claims that it is exempt from income tax upon the income of this fund. The claim for the refund of the tax paid has been written up for rejection on the ground that the fund is a trust fund and that the income of a trust fund of this character is subject to income tax. It is stated in the finding of facts:

* * * inasmuch as the evidence in the case shows that the trust was created for the benefit of unascertained persons and is still in process of administration, it is held that it is properly taxed as an entity under the provisions of section 2 (b) of the Act of October 3, 1917, or that portion of the income accruing to it which had not been distributed. This conclusion has been reached notwithstanding that an examination of the documentary evidence in the case shows that the trust was created for a charitable purpose and that no part of its net income inures to the benefit of any private individual, because there is no provision of law under which any income accruing to trusts created for charitable purposes is exempt from income tax.

This trust fund is similar to the trust funds held by a great many cities and towns throughout the United States. Money is given to a city or town in trust to use the income therefrom for charitable purposes, the support of a hospital, schools, maintenance of a park, or for some other purpose ordinarily recognized as a municipal function. In municipal accounting the assets of such trust funds accepted by a city are generally regarded as the assets of the city, and the income of the funds as municipal revenues. Thus, the Bureau of the Census, in its statistics of cities published annually, includes in its statements of the assets of cities the assets of such trust funds and includes in the municipal revenues the income of such funds.

It is a fundamental principle in the interpretation of Federal taxing statutes that they shall not be construed so as to impose a tax upon the income of States, or political subdivisions of States, providing such income arises from the normal governmental functions of the State or political subdivision. In the case of United States *v.* Railroad Company (17 Wall., 322, 327), the United States Supreme Court stated:

> The right of the States to administer their own affairs through their legislative, executive, and judicial departments, in their own manner through their own agencies is conceded by the uniform decisions of this court and by the practice of the Federal Government from its organization. This carries with it an exemption of those agencies and instruments from the taxing power of the Federal Government.

The only question for determination in the present opinion appears to be whether the income of the fund is used for a municipal purpose.

In view of the facts of the case it is held that the Y City, through the board of commissioners of the fund, was discharging a strictly governmental function in discharging the trust in question.

This case is sharply to be differentiated from the case of South Carolina *v.* United States (199 U. S., 437) in which the United States Supreme Court held that when a State engages in a private business that business is not withdrawn from the taxing power of the Federal Government. Where a city accepts money in trust, the income to be used for the support of the poor, the administration of the trust must be regarded as a public and governmental rather than a private activity.

It is held that where property is willed to a municipality in trust that the income of the property shall be used for a public charity the income is not liable to Federal income tax and the trustees of the fund are not required to file annual tax returns.

Section 213 (b), Article 84: Income of States. 14–19–434.
O. D. 250.

Certain townships and a county constructed the X Railroad and subsequently leased it to the Y Railroad for a number of years for an annual consideration. The rental, after the payment of actual expenses, being divided between the respective townships and county on the basis of ownership, is income derived from a public utility and as such is not taxable under section 213(b) of the Revenue Act of 1918. The X Railroad, however, must file a return of income.

Section 213 (b), Article 84: Income of States. 28–19–612.
(Also Section 216, Article 301.) O. D. 328

A corporation is organized to furnish water, light, power, and heat to a town. The town owns practically all the common stock, upon which no dividends are to be paid. The preferred stock is to be redeemed as soon as possible out of earnings, after which the plant becomes the property of the town. Income derived by the corporation from the operation of such plant is exempt from tax in accordance with section 213(b) 7, Revenue Act of 1918, since the imposition of the tax would delay the redemption of the preferred stock, thereby imposing " a loss or burden " on the town.

However, the corporation must file returns of annual net income. Dividends received by holders of the preferred stock of the corporation are not an allowable credit against net income for the purpose of the normal tax.

Section 213 (b), Article 85: Compensation of State officers. 3–19–179. T. D. 2843

Salaries of State officials and salaries and wages of employees of a State are not liable to income tax imposed by the Revenue Act of 1918.

Section 213(a) of the Revenue Act of 1918 provides that gross income shall include " gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid."

In accordance with an opinion of the Attorney General, dated May 6, 1919, and based on the well-settled rule that governmental agencies of the States are not subject to taxation by the Federal Government, it is held that salaries of State officials and salaries and wages of employees of a State are not subject to the income tax imposed by the said Revenue Act of 1918.

Section 213 (b), Article 85: Compensation of State officers. 4–19–214. O–826

EXEMPTION FROM INCOME TAX OF TEACHERS IN INSTITUTION FOR INSTRUCTION OF DEAF-MUTES.

Salaries paid to teachers are exempt from income tax only where the educational institution is maintained wholly by the State and the relation of employer and employee exists between the State and the teacher. They are not exempt merely because engaged in educational work or because they are pensioned by the State. (Revenue Act of 1916, sec. 4; Revenue Act of 1918, sec. 213(a).)

The Revenue Act of 1916 exempted from income tax " the compensation of all officers and employees of a State." (Sec. 4.) The same section of the act also exempted the compensation of the President and certain Federal judges. The Revenue Act of 1918 abrogates the latter provision and expressly taxes the compensation of all officers and employees of the United States, including the President and Federal judges. (Sec. 213a.) As to State employees, the previous exemption is omitted, but no provision is substituted, as in the case of Federal employees, expressly subjecting the compensation to tax.

It has been a familiar principle for many years on the one hand.

that the States have no power to tax the instrumentalities of the Federal Government; on the other, that the Federal Government has no power to tax the instrumentalities of the various States. The exemption provision in the Act of 1916 was evidently due to this principle, and indicates compliance with a supposed limitation of power. The omission of the exemption in the Act of 1918 strengthens this view. It follows that the exemption, both in the Act of 1916 and that of 1918, extends only to those cases in which the exercise of the taxing power by the Federal Government would constitute an undue infringement upon the powers of the States.

The reason and extent of the limitation are thus stated:

> The exemption rests upon necessary implication, and is upheld by the great law of self-preservation; as any government, whose means employed in conducting its operations, if subject to the control of another and distinct government, can exist only at the mercy of that government. Of what avail are these means if another power may tax them at discretion? (Collector *v.* Day, 11 Wall. 113, 127.)

The exemption thus extends only to "the means employed (by the State) in conducting its operations"; that is to instrumentalities necessary to enable the State to exercise its governmental duties. The actual decision in Collector *v.* Day harmonizes with the language used. It was that Congress has no power to impose a tax upon the salary of a State judge; that is, to tax an instrumentality necessary to the performance of the strictly governmental duty of administering the law.

The limitations of the rule are well exemplified by the South Carolina dispensary case. (South Carolina *v.* United States, 199 U. S., 437.) It was held in this case that persons engaged in the selling of liquor are not exempt from the tax imposed upon such persons (R. S., secs. 3140, 3232, 3234), because acting as agents of the State of South Carolina, which had taken charge of the business of selling intoxicating liquors. It was conceded that "the regulation of the sale of liquor comes within the scope of the police power," that "the police power is in its fullest and broadest sense reserved to the States," and that Congress "may do nothing by taxation in any form to prevent the full discharge by the (State) of its governmental functions"; but it was nevertheless held that "whenever a State engages in a business which is of a private nature that business is not withdrawn from the taxing power of the Nation" (pp. 453–454, 463). This decision establishes that action of the State in the legitimate exercise of its police power is not necessarily an exercise of those governmental functions interference with which is unlawful. The whole scope of the opinion indicates a tendency to restrict the limitation of the Federal power to tax so as to prevent interference only with the strictly governmental functions of the State. The danger of any other rule, in impairing internal-revenue taxation, is considered at length (pp. 452–453).

The teachers now in question are not embraced within the class to which the exemption applies. Education is undoubtedly a subject of great public importance, in which the State takes an extensive interest. The function of education, however, is not exclusively a governmental one. The State is not required to undertake it; and it is often carried on by private individuals for profit. The fact that it is a proper subject for State regulation does not prove that a teacher is an "employee" of the State. That depends upon the circumstances of the particular case. It is not enough to show that the taxpayer is engaged in educational work, and that the State is interested in the subject of education. Educational institutions are, by special provision, exempt from income tax; but the exemption has not been extended to their employees.

The question whether any particular teacher is an "employee" of the State should be determined by the familiar tests. The relation of employer and employee implies the payment by the employer of the wages of the employee, and the existence of the right to control the exercise of his duties and to discharge him. Neither fact appears in the present case. The institution is conducted, primarily, by private effort and private funds. The State and the various counties send pupils to it, and pay for their support. This payment, however, is for services rendered, and is made to the institution, not to the teachers. Their salaries are paid by the institution, not by the State. The power to control and discharge the teachers is also vested in the institution. The State has powers of visitation over the institution itself, but does not interfere in the details of its management.

Stress is laid upon the fact that teachers in the institution may receive pensions from the State; but the very legislation relied upon makes against the theory that they are State employees.

Prior to 1915 the education law of the State provided as follows:

> Every teacher in a State institution who, for a period of 10 years immediately preceding, has been employed by the State as a teacher in any college, school, or institution maintained and supported by the State, and who shall have been engaged in teaching in some college, university, school, academy, institution, teachers' institutes, or in the public schools of this State or elsewhere during a period aggregating 30 years must, at his request, or may on the order of the commissioner of education, be retired from such employment. (Cons. Laws, chap. 16, sec. 1095.)

And every person so retired is entitled to a pension (sec. 1098).

By chapter 614 of the laws of 1915, section 1095 was amended to read as follows:

> Every teacher in a State institution and in an institution for the instruction of the deaf and dumb and the blind, receiving State pupils whose instruction and support are paid for by the State, who, for a period of 10 years immediately preceding, has been employed as a teacher in any college, school, institution, or teachers' institutes maintained and supported by the State, etc.

It thus appears that, prior to 1915, it was required that a teacher should, for a period of 10 years, have been "employed by the State." The amendatory statute expressly includes the case of teachers in institutions for the instruction of the deaf, dumb, and blind. Special provision for this case, however, indicates that it was thought that they did not come within the previous provisions, as persons "employed by the State"; and the context supports this view. The institutions for the deaf, dumb, and blind are described as institutions "receiving State pupils whose instruction and support are paid for by the State"; and this contrasts with the description of evidently the legislative theory that the mere receipt by an institution of the State pupils did not make it an institution supported by the State, or its teachers employees of the State.

The receipt of a pension does not stamp the recipient as an employee of the State or government making the grant. Many illustrations could be given to prove this statement.

It is held, therefore, that the teachers in question are not exempt from income tax.

Section 213 (b), Article 85: Compensation of State officers. 1–19–45. O. D. 33.

Compensation paid to a county surveyor from county funds, even though on a per diem basis, is free from tax.

Section 213 (b), Article 85: Compensation of State officers. 16–19–459. O. D. 256.

An individual who exercises a public function under an appointment issued by a court officer for a particular transaction or purpose for a limited time, and in the exercise of such function is not invested with the character of either an officer or employee of the State or political subdivision thereof, is not considered to be such a State official or employee whose compensation is exempt from Federal income tax under the provisions of article 85 of Regulations 45 and Treasury Decision 2843.

The designations "State officers" and "employees of a State" refer only to those persons who are in the regular and continual service of the State or a political subdivision thereof within the ordinary acceptance of these terms. Accordingly, administrators and executors, whether or not they are considered to be officers of the court in the performance of their duties, are not exempt from Federal income tax on the compensation received for their services.

Section 213 (b), Article 85: Compensation of State officers. 16–19–460. O. D. 257.

The members of the Virginia debt commission, created by act of the legislature of the State for the purpose of discharging a governmental function, are considered to be State officers and compensation received by them for services rendered in their official capacity is exempt from Federal income tax.

Section 213 (b), Article 85: Compensation of State officers. 19–19–497. O. D. 274.

Compensation paid by a State or political subdivision to its officers and employees is not subject to the income tax imposed by the Revenue Act of 1918, even though the recipient is a nonresident alien.

Section 213 (b), Article 85: Compensation of State officers. 25–19–582. O. D. 309.

A chief engineer appointed by a sewerage commission created by the common council of a city under authority of a State statute, is considered to be an employee of a political subdivision of a State and the compensation paid him is not taxable.

Section 213 (b), Article 85: Compensation of State officers.

(See 9–19–338, sec. 213(a), art. 31.) Taxability of fees received by a witness summoned by a State attorney.

Section 213 (b), Article 86: Compensation of soldiers and sailors. 1–19–39. O. D. 27.

Employees of the Commission on Training Camp Activities, as such, are not considered to be persons in active service in the military or naval forces of the United States, and, therefore, are not entitled to the exemption allowed by section 213 (b) 8, Revenue Act of 1918.

Section 213 (b), Article 86: Compensation of soldiers and sailors. 1–19–41. O. D. 29.

A civilian governed by the rules and regulations of the American Expeditionary Forces is not termed a person in the military forces of the United States within the meaning of section 213(b) 8, and therefore is not entitled to the $3,500 exemption provided in that section.

Section 213 (b), Article 86: Compensation of soldiers and sailors. 3–19–182. O. D. 121.
(Also Section 218, Article 322.)

A member of a partnership who has performed services in the military forces of the United States during the present war, and according to agreement has turned over to the partnership the compensation received for such services, may in reporting his distributive share of the partnership's income, exclude from his return an amount equal to the sum received for military services and turned over to the partnership, but not in excess of $3,500. The other partner must report his entire distributive share of the income regardless of the fact that a portion of it was derived from his partner's compensation for military services.

Section 213 (b), Article 86: Compensation of soldiers and sailors. 3–19–183. O. D. 122.

Compensation received from the United States War Department by a civilian flying instructor for services rendered during the present war does not come within the exemption provided by section 213(b)8 of the Revenue Act of 1918 for compensation for active military service performed during the present war.

Section 213 (b), Article 86: Compensation of soldiers and sailors. 3–19–184. O. D. 123.
(Also Section 216, Article 302.)

The personal exemption allowed a married man and the exemption for dependents are not included in the $3,500 compensation for active service in the military or naval forces of the United States during the present war exempt from tax under section 213(b)8 of the Revenue Act of 1918.

Section 213 (b), Article 86: Compensation of soldiers and sailors. 11–19–376. O.D. 214
(Also Section 213 (a), Article 31.)

Only such portion of amounts received by persons in the military service of the United States representing compensation for services in the Army and which was paid by the War Department is exempt from tax under section 213(b)8 of the Revenue Act of 1918.

Accordingly, the compensation received from the Spruce Division by a person in military service engaged in cutting spruce is taxable and should be included in his returns.

Section 213 (b), Article 86: Compensation of soldiers and sailors. 28–19–613. O.D. 329.

Persons serving during the present war in the American Merchant Marine Sea Training Bureau are not entitled to the $3,500 exemption provided in section 213(b)8, Revenue Act of 1918.

Section 213 (b), Article 86: Compensation of soldiers and sailors. 29–19–625. O.D. 337.

Section 213(b)8, Revenue Act of 1918 applies only to 1918 and subsequent years and may not be applied retroactively to salary or compensation received for active service in the military or naval forces of the United States between April 6, 1917, and December 31, 1917.

Section 213 (c).—GROSS INCOME DEFINED: NONRESIDENT ALIEN INDIVIDUAL.

Section 213 (c), Article 91: Gross income of nonresident alien individuals. 9–19–340. T. D. 2876.

Decision under Revenue Act of 1913.

The income received by a nonresident alien from stocks and bonds of corporations organized under the laws of the United States and bonds and mortgages secured upon property in the United States, the certificates representing the same being held by a domestic trust company under a power of attorney which gave authority to the agent to sell, assign, or transfer any of them and to invest and reinvest the proceeds, is property owned in the United States within the meaning of the act of October 3, 1913.

Section 213 (c), Article 91: Gross income of nonresident alien individuals. 13–19–417. O. D. 239.

Interest on bonds of a nonresident foreign corporation payable in the United States to a nonresident alien is not income from sources within the United States.

Section 213 (c), Article 91: Gross income of nonresident alien individuals. 23–19–543. O. D. 291.

An alien who comes to the United States with merchandise which he disposes of in this country is subject to tax with respect to the profit derived from such activities, even though he is within the United States for a period of less than 30 days.

Section 213 (c), Article 91: Gross income of nonresident alien individuals.

(See 23–19–549; sec. 233, art. 550.) Taxability of income of nonresident alien from sales within United States by mail-order business or on unsolicited orders.

Section 213 (c), Article 92: Income of nonresident alien individuals not subject to tax. 1–19–16. O. 786.
(Also Section 221, Article 361.)

Where bonds, notes, or other obligations of a foreign Government are underwritten by a United States banking establishment and are by their terms payable at an office of such banking establishment in the United States, interest paid from the United States office to nonresident alien individuals or foreign corporations who are holders of such securities is not to be regarded as income received from a source within the United States.

A question is raised as to the withholding obligation of a United States banking house, which pays interest to nonresident alien individuals or foreign corporations holding notes of a foreign government. Section 213 (c) of the Revenue Act of 1918 is as follows:

In the case of nonresident alien individuals, gross income includes only the gross income from sources within the United States, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise), representing profits on the manufacture and disposition of goods within the United States.

It appears that the notes in question are obligations of a foreign Government, but are payable at the United States offices of a United States banking establishment, which underwrote them. Articles 91 and 92, Regulations 45, Preliminary Edition, discuss the meaning of the word "sources," as regards the income of nonresident alien individuals, but do not expressly cover this case. The mere fact that disbursement of interest and principal on these obligations is to be made in the United States is not conclusive that such amounts are received from a United States source. The question as to the source of income must be decided upon some more definite basis than the place of payment or the nationality of the paying agent. These matters may be determined by the parties without affecting the real substance of the transaction.

It is held, therefore, that where bonds, notes, or other obligations of a foreign government are underwritten by a United States banking establishment, and are by their terms payable at an office of such banking establishment in the United States, interest paid from the United States office to nonresident alien individuals or foreign corporations, who are holders of such securities, is not to be regarded as income received by them from a source within the United States and therefore not subject to withholding.

Section 213 (c), Article 92: Income of nonresident alien individuals not subject to tax. (Also Section 221, Article 361.) 18–19–478. O. 908.

REVENUE ACT OF 1918, SECTIONS 213 (C) AND 221 (B).

Interest on tax-free covenant bonds of corporations organized in the United States doing no business and owning no property therein paid to nonresident aliens is not subject to taxation as income received from sources within the United States.

Section 213 (c) of the Revenue Act of 1918 provides:

(c) In the case of nonresident alien individuals gross income includes only the gross income from sources within the United States, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods, within the United States.

Section 221 (b) provides in part:

(b) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee * * * the obligor shall deduct and withhold a tax equal to 2 per cent of the interest upon such bonds, mortgages, deeds of trust, or other obligations * * * whether payable to a nonresident alien individually or to an individual citizen or resident of the United States * * *.

The X Company was organized in the United States. However, it operates exclusively abroad and does no business and owns no property in the United States. Certain of the tax-free covenant bonds of the company are owned by nonresident aliens and the question arises as to whether the interest paid on such bonds to the nonresident alien individual owners is subject to withholding.

Gross income in the case of nonresident alien individuals includes only "gross income from sources within the United States," including, among other things, the interest on bonds of "residents, corporate or otherwise." Section 221 (b), requiring the withholding of a tax of 2 per cent of the interest payable on tax-free covenant bonds, whether payable to nonresident alien individuals or to citizens or residents of the United States, must be read in connection with section 213 (c). This is evident from the fact that section 221 (b) expressly refers to "the tax imposed by this title," which is "Title II—Income tax" on individuals. Thus, withholding of interest on tax-free covenant bonds owned by nonresident alien individuals is only required when the interest is "from sources within the United States;" that is, when the interest is paid by "residents, corporate or otherwise." (Law Opinion 397.) But a corporation organized in the United States is not necessarily a resident of the United States. As stated in that opinion:

From this use of language it appears that "domestic" and "resident" are not synonymous—a foreign corporation may be a resident corporation—and that residence and citizenship of a corporation are analogous, respectively, to residence and citizenship of an individual. Though a corporation is usually said to be a resident where organized, for the purposes of this statute the country in which the corporation is organized is to be regarded as determining its citizenship and not its residence. A domestic corporation is to be treated as a citizen and a foreign corporation as an alien. Residence within the United States requires some localization, such as being engaged in business or trade or having an office or place of business therein.

Compare Brand *v.* Auto Service Company (75 N. J. L. 230, 67 Atl. 19). In Law Opinion 397 it was held that interest on notes of a corporation organized in the United States but owning no property and doing no business therein was not subject to tax. This opinion was expressly followed in article 92, Regulations 45. Interest upon bonds of a domestic corporation owning no property and doing no business in the United States should not be differently treated.

It is held, therefore, that interest on tax-free covenant bonds of corporations organized in the United States, doing no business and owning no property therein, paid to nonresident aliens is not subject to taxation as income received from sources within the United States.

Section 213 (c), Article 92: Income of nonresident alien individuals not subject to tax. 1–19–47. O. D. 35.

The interest on bonds and notes of foreign countries, owned by nonresident aliens, is not subject to income tax in the hands of the recipients, whether paid in the United States or abroad, nor is a profit realized on foreign exchange from such payment taxable.

Section 213 (c), Article 92 (a): When the wages of a nonresident alien are derived from sources within the United States. 8–19–316. T. D. 2869 (1).

The final edition of Regulations 45 is amended by inserting immediately after article 92 a paragraph to be known as article 92a, as follows:

ART. 92a. *When the wages of a nonresident alien are derived from sources within the United States.*—While resident alien seamen are taxable like citizens on their entire income from whatever sources derived, nonresident alien seamen are taxable only on income from sources within the United States. Ordinarily, wages received for services rendered inside the territorial United States are to be regarded as from sources within the United States. The wages of an alien seaman earned on a coastwise vessel are from sources within the United States, but wages earned by an alien seaman on a ship regularly engaged in foreign trade are not to be regarded as from sources within the United States, even though the ship flies the American flag, or although during a part of the time the ship touched at United States ports and remained there a reasonable time for the transaction of its business. The presence of a seaman aboard a ship which enters a port for such purposes of foreign trade is merely transitory, and wages earned during that period by a nonresident alien seaman are not taxable. There is no withholding from the wages of alien seamen unless they are nonresidents within the rules laid down in articles 311 to 315. Even in the case of a nonresident alien seaman the employer is not obliged to withhold from wages unless those wages are from sources within the United States as defined above. As to when alien seamen are to be regarded as residents see article 312a.

Section 213 (c), Article 92 (a): When the wages of a nonresident alien are derived from sources within the United States.

(See 13–19–424, sec. 221, art. 361. Wages earned on vessels making occasional coastwise voyages.

Section 214 (a) 1.—DEDUCTIONS ALLOWED: BUSINESS EXPENSES.

Section 214 (a) 1, Article 101: Business expenses. 8–19–317.
(Also Section 215, Article 292.) S. 1048.

The cost of transportation paid by a salaried employee living at a distance from his employment, in order to go to and return from such employment is not deductible as a business expense.

Opinion has been requested whether the cost of transportation paid by a salaried employee, living in one city but employed in another city, in order to go to and return from such employment, is deductible as a business expense in the computation of net income in income tax returns.

Section 214(a) (1) of the Revenue Act of 1918 provides that in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.

Section 215(a) provides that no deduction shall be allowed in the computation of net income in respect of "personal, living, or family expenses."

The provisions of the Acts of October 3, 1913, and September 8, 1916, are to the same effect. (See sec. 2, subd. B, Act of Oct. 3, 1913, and sec. 5(a) of the Act of Sept. 8, 1916.)

Railroad fares paid out in connection with trips undertaken for and on account of business have been held to be deductible as a necessary expense of business. Whether such fares are a business expense is to be determined by the facts in each case. If the trip is undertaken for other than business purposes, such railroad fares are personal expenses. (See art. 292 of Regulations 45.) On the other hand, commuters' fares in going to and returning from work, notwithstanding such trips are made because of business, have been held to be a personal expense. (See question 58, Income Tax Primer (revised Mar. 1, 1919).) In England the decisions on the same question have been to the same effect as the answer to question 58. (See Cook *v.* Knott, 2 Gt. Bn. Tax Cases, 246; Revell *v.* Directors, 3 Gt. Bn. Tax Cases, 12.)

"Business expenses," as defined in article 101, Regulations 45, includes all items entering into what is ordinarily known as the cost of goods sold, together with selling and management expenses. In short, every necessary item of expense in conducting business, incurred primarily because of and solely in the furtherance of the business engaged in, is held to be an ordinary and necessary business expense.

To what extent can this definition of business expenses be applied? Does it include any and all expenses which in any way bear upon or have a relation to or a connection with the business engaged in by the individual? Obviously, amounts paid out for medical attention necessary for the upkeep of the body and the preservation of health are personal and have no connection with business. Likewise, sums paid to the grocer, to the tailor, amounts paid for insurance and house rent. These expenses arise independently of business. The test, therefore, is whether an expense is incurred primarily because of business as the immediate cause inducing the expenditure.

Does the expense incurred by the commuter for transportation to and from his employment meet the test above set forth? Obviously, an individual is free to fix his residence wherever he chooses. He fixes it according to his personal convenience and inclinations, as a matter separate and apart from business. Any expense, therefore, incident to such residence as fixed by the individual is a matter personal to him. If he prefers, for personal reasons, to live in a different city from that in which his business or employment is located, any expense incident to so doing is the result of decision based upon personal convenience and preference, and it is not the result of anything undertaken for business purposes and, therefore, is not a business expense.

It is therefore held that the cost of transportation paid by a salaried employee living at a distance from his employment, in order to go to and return from such employment, is not deductible as a business expense within the meaning of the Revenue Acts of October 3, 1913, September 8, 1916, as amended, and February 24, 1919.

Section 214 (a) 1, Article 101: Business expenses. 3–19–187.
T. B. R. 13.

Deductibility of "Crop Insurance" in the Canning Industry.

Amounts set aside by canners of perishable food products, as a reserve against which to charge losses due to climatic and other natural conditions producing shortage of the raw product, not deductible in computing net income.

The present recommendation is made in response to a request that reserves for crop insurance be allowed as deductions from gross income.

The argument of the petitioners, briefly summarized, is as follows:

The canning industry is peculiarly subject to localized climatic conditions which greatly affect the output from year to year.

The expenses of a cannery being to a large extent constant, the result is that the cost per unit of output is much less in the year of large crops than in the years of crop failure.

The climatic conditions being local rather than general, the high cost per unit in the years of scant crops is not compensated by the higher prices of output; and there results an alternation of abnormally high profits and abnormally low profits, depending on the alternation of favorable and unfavorable climatic conditions.

On the theory that these changes follow a somewhat definite cycle, it is claimed that an equitable adjustment would be secured by establishing a reserve for crop insurance as suggested above.

The Revenue Act recognizes that in any business the profits may vary from year to year. It deliberately adopts the policy of levying additional taxes on annual profits above the average. It does not make any corresponding reduction for a year in which the profits are below the average. An actual net loss in one year may, under section 204, be offset against net profits of another year, but this is a special relief provision limited in its application to the narrow class of cases covered by that section. The equalization of profits between years which show no loss or the accumulation of reserves against future losses are not sanctioned by the law. In general, the statute evidences a clear intent to restrict within the narrowest limits deductions for addition to reserves other than the reserves of insurance companies required by law. It is doubtful even whether a reserve against an incurred but unpaid liability can be recognized, when the liability is at all indefinite. But there can be little doubt that a reserve against a future loss is unrecognized by the statute, and no doubt at all that a reserve against fluctuations in future profits has no standing of a kind which would warrant the deduction of additions thereto in computing net income for purposes of taxation.

The allowance of a charge for crop insurance clearly differs from the allowance for depreciation in the element of definiteness of calculation. The certainty of depreciation is unquestioned, and the life of the depreciating asset can be estimated with a fair approximation of accuracy. But even the depreciation allowance is given by virtue of express statutory authority.

The theory of a regularly recurring crop cycle, particularly as limited to localized industries, is still a theory. The particular theory of a crop cycle cited in the petitioner's brief refers to a general world-wide cycle. Such a cycle is deliberately ruled out of consideration by the petitioners who claim that while a general shortage of crops would in part be compensated by higher prices, the shortages for which they wish to provide are local shortages in closely contiguous territory which are so limited as to have no noticeable effect on general market prices.

The petitioners claim that if a crop insurance reserve is capable of being determined with reasonable certainty, it is an allowance the canner has a legal right to claim but admit also that crop insurance has entering in it so many variable factors that no insurance companies will write the risks. The petition therefore in part rests on a debated economic theory which relates at best to conditions not applicable to the case at issue, and in part on an admittedly nonexisting accuracy of calculation.

The request is in effect a proposal to equalize profits in a manner not contemplated by the Act, and it is accordingly recommended that the petition be denied.

Section 214 (a) 1, Article 101: Business expenses. 1–19–55.
O. D. 38.

If a creditor takes out a life insurance policy on an individual to cover loans to the individual, the creditor may, while the loan is outstanding, deduct from gross income as a necessary expense the amount of the premiums paid during the year for which the return is made.

Section 214 (a) 1, Article 101: Business expenses. 11–19–377.
(Also Section 234, Article 561.) O. D. 215.

Any amount paid as a premium on crop insurance taken out as a protection against a loss which may occur on account of crop conditions would constitute an allowable deduction as a business expense.

Section 214 (a) 1, Article 101: Business expenses. 25–19–583.
O. D. 310

An amount expended by a Member of Congress for clerk hire, in excess of the allowance made by the Government, may be properly deducted as a business expense.

Section 214 (a) 1, Article 101: Business expenses.

(See 1–19–38, sec. 213 (a), art. 31.) Effect of Federal taxes paid in connection with amounts paid on account of patent infringement.

Section 214 (a) 1, Article 101: Business expenses.

(See 23–19–551, sec. 250, art. 1002.) Penalties added to tax: when deductible as business expense.

Section 214 (a) 1, Article 101: Business expenses.

(See 26–19–595, sec. 250, art. 1003.) Deduction of interest on taxes.

Section 214 (a) 1, Article 105: Compensation for personal services. 15–19–444. T. B. R. 46.

Revenue acts of 1916, 1917, and 1918.—Compensation for personal services.

In the determination of the tax liability of the X Company for the year 1916 under the Revenue Act of 1916 the question has arisen as to the amounts to be allowed as deductions from gross income for salaries of officers. It appears that, in addition to salaries described as "nominal," considerable sums were paid to the officers of the corporation upon the basis of percentages of the profit remaining after payment of a dividend to the stockholders. Such percentages apparently bore no relation to the stockholdings of the officers.

The controlling principles as to deductible allowances for officers' salaries and compensation for personal services generally were stated in Treasury Decision 2696 and are embodied in article 105 of Regulations 45. The same rules are applicable to the Revenue Acts of 1916, 1917, and 1918. "The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services." (See article 105, supra.) The facts submitted in the present case are not sufficient to warrant a determination of the amounts properly allowable as deductions for salaries paid in the year 1916. The ruling requested is, however, merely as to what limit shall be placed on a distribution, on a percentage basis, of profits to officers of the above-named company, who receive only nominal salaries. It is impossible to fix a maximum limit applicable to salaries generally. The allowance in each case must be "what is reasonable in all the circumstances" (see article 105, supra), and it can not be laid down as a general rule that any given sum is necessarily more than is reasonable under any circumstances. Clearly, it can not be said that salaries in excess of a certain amount are always unreasonable and that the excess over that amount should invariably be disallowed. Of course, all claims for large salary deductions, especially in cases of salaries based upon percentages of profits, should be scrutinized in the light of the regulations.

It is held, therefore, that the department is not warranted in fixing any amount as a maximum limit for deductions for officers' salaries and compensation for personal services, but that each case must be decided in the light of all its circumstances.

Section 214 (a) 1, Article 105: Compensation for personal services. 18–19–481. T. B. M. 70.

A close corporation operated for a number of years prior to 1917, sometimes making moderate losses and sometimes moderate profits, paying only nominal salaries to its officers. In 1917 it was highly successful and distributed to the five stockholders who are also officers approximately 12 per cent of its net income, in exact proportion to their stock holdings. Of the total amount distributed 18 per cent was paid currently during the year and 82 per cent was paid on or about the close of the year 1917. In view of the salaries paid by other companies in the same line, doing a corresponding volume of business, the aggregate salaries paid appears to be excessive; and as some of the officers receiving the largest salaries did not devote all of their time to the work, a substantial part of the so-called salaries would seem to be nothing more than a distribution of profits. Forty per cent of the deduction taken for above salaries was not allowed.

Section 214 (a) 1, Article 105: Compensation for personal services. 22–19–534. T. B. M. 86.
(Also Section 234, Article 561.)

Salaries voted subsequent to the close of any taxable year, and also subsequent to the close of the books for such taxable year, can not be considered an ordinary and necessary expense of doing business.

In the case of the M Company, A, B and Company, and O Company appeals were made from the adverse decision of the Income Tax Unit with regard to certain salaries, bonuses, and fees which were voted at various dates in 1919 to cover the calendar year 1918. The facts are agreed upon by the taxpayers and the Income Tax Unit, and the only question at issue is whether in the absence of a contract obligation, salaries, bonuses, and fees voted after the close of the taxable year are properly deductible from gross income of such taxable year in the return of annual net income.

The argument has been presented that the language of the law clearly warrants this, and that in section 234 (a) (1) the provision that—

all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered—

means that a reasonable allowance for salaries, etc., may be taken as a deduction regardless of when or how such salaries were paid. It is presented that the reasonable allowance for salaries or other compensation for personal services actually rendered is a deduction allowed in addition to all the ordinary and necessary expenses paid or incurred and is in fact simply a measuring rod used in determining taxable net income under the law. The argument is set forth in full in the brief and need not be repeated here. The facts are also shown in each case in a very carefully prepared statement, and the Income Tax Unit and the corporations are in agreement as to the amount of reasonable salaries and bonuses which shall hereafter be recognized as proper deductions.

The Advisory Tax Board can not concur in the interpretation placed by the attorney for these corporations on the language of section 234 (a). Salaries and wages have always been considered ordinary and necessary expenses incurred in carrying on any trade or business, and in recent years bonuses have also become ordinary and necessary expenses. Had the additional words "including a reasonable allowance for salaries or other compensation for personal services actually rendered" been omitted from the law, there is not the least doubt but that such salaries and other compensation would nevertheless have been allowed as proper deductions. The real significance of these words is that the allowance for salaries or other compensation for personal services must be *reasonable*, and only a reasonable allowance can be taken as a deduction.

The word "including" indicates clearly that the latter part of the sentence under consideration can not be separated from the first part in the manner argued by the attorney. "Include" means to inclose within; to embrace as a component part. Such being the case, these payments do not fulfill the requirements of the law so as to make them proper deductions. While ordinary and necessary expenses, they were neither paid nor incurred during the taxable year. It is admitted that there was no contract obligation or even moral obligation to make these payments.

Having been neither incurred nor paid during the taxable year, it is the opinion of the Advisory Tax Board that the amounts paid in 1919 for increases in salaries, bonuses, and directors' fees for the year 1918 are not properly deductible from the gross income of that year. This is in accordance with the decision already made by the Income Tax Unit. The Advisory Tax Board is further of the opinion that these increases not having been incurred or paid in the year 1918, the payments made would not be deductible from gross income in ascertaining net income for income and excess-profits tax purposes either in the return of annual net income for 1918 or any subsequent year. The Advisory Tax Board recommends that the decisions of the Income Tax Unit in the above cases be confirmed, and further that the amounts voted and paid in 1919 as additional compensation for the year 1918 be barred as a deduction in the return of annual net income of any year.

Section 214 (a) 1, Article 105: Compensation for personal services

(See 10–19–362; sec. 234, art. 561.) Excessive compensation.

Section 214 (a) 1, Article 105: Compensation for personal services.

(See 23–19–554; sec. 326, art. 851.) Compensation paid officers based on percentage of gross sales of each.

Section 214 (a) 1, Article 106: Treatment of excessive compensation.

(See 8–19–319; sec. 311, art. 781.) Adjustment of salaries paid during prewar period.

Section 214 (a) 1, Article 107: Bonuses to employees. 1–19–54. O. D. 37.

Assuming books and returns on an accrual basis, deductions representing a distribution to employees as additional compensation of a percentage of the net earnings of a corporation are allowable only in the return for the year in which such expense was incurred. If reported otherwise amended returns should be filed.

Section 214 (a) 1, Article 107: Bonuses to employees. 3–19–186. O. D. 124.

A proportionate part of the par value of a company's stock delivered to a trustee to be held in escrow for the benefit of certain employees of the company which stock is to be delivered to them at the expiration of a number of years in recognition of faithful service, may be taken as a deduction in the income tax returns of the company for each of such years during the period the trustee holds the stock, providing the corporation keeps its books on an accrual basis.

If the employee for whom the stock was deposited should forfeit his right to receive the stock, the corporation must report as income in the year in which the right to receive the stock is forfeited, the amounts taken as a deduction in previous years on account of the forfeited stock.

Section 214 (a) 1, Article 111: When charges deductible. 1–19–94. S–923.

Deductibility of a damage claim not finally adjudicated against the taxpayer in a taxable year, but later reduced to judgment.

In 1914, in a case in which the taxpayer was defendant, it was adjudged by interlocutory decree over the taxpayer's objection that the taxpayer had infringed a valid patent belonging to the plaintiff, and the case was referred to a master in chancery on that date to state on account of the profits received by the defendant and assess the damages sustained by the plaintiff by reason of such infringement.

In 1918, the master's report in the case was filed assessing the profits and damages sustained by the plaintiff at the sum of x dollars. Exceptions were filed to this report by both plaintiff and defendant, and in 1919 the court entered a decree confirming the report in question and finding that there was due to the plaintiff the amount found by such report, together with interest thereon from 1918, the date of filing the master's report. The defendant has not yet determined whether to acquiesce in this decree or whether it will be able to file the necessary bond to carry the case to a higher court. The books of the defendant corporation are kept on an accrual basis. On account of the pendency of this suit the books of the corporation were not closed at the end of the corporation's taxable year, but have been kept open awaiting the judgment.

The question now arises whether any part of the amount of judgment is deductible in ascertaining the net income of the defendant corporation for the taxable year 1918.

In section 234, Revenue Act of 1918, it is provided that in computing the net income of a corporation there shall be allowed, among other deductions, "losses sustained during the taxable year and not compensated for by insurance or otherwise."

In law opinion 475 it was held that, "where a judgment was obtained against a corporation by reason of alleged infringement of a patent during previous years," such judgment, so far as it was based on damages to the plaintiff or profits of the defendant, constituted a deductible loss under the Act of October 3, 1913, for the year in which paid; but that opinion throws no light on the question as to whether any loss in the present case was "sustained" during the taxable year 1918.

In view of the fact that the determination of the damages in this case by the master was purely advisory to the court, and the court was not in any sense bound to follow such recommendation, the determination by the master, which was subsequently confirmed by the court, can not be regarded as a determination of the amount of the claim.

Compare Regulations 45, article 111.

It is held that no deduction for the year 1918 is permissible in regard to the judgment referred to.

Section 214 (a) 1, Article 111: When charges deductible. 1–19–6. O. D. 3.

A receiver of a corporation may deduct receiver's and attorney's fees actually paid during the year to which the return relates, if the books are kept on the basis of cash receipts and disbursements; if the books are kept on the accrual basis, the amount of such fees accruing during the taxable year may be deducted even though the disbursement was not actually made until the following year.

Section 214 (a) 1, Article 111: When charges deductible. 5–19–260. O. D. 159.

A corporation may set up on its books in 1918 a contingent liability without prejudicing its rights to deduct the item in a proper year, although the same is not deductible in 1918.

Section 214 (a) 1, Article 111: When charges deductible.

(See 3–19–188; sec. 234, art. 561.) When payments of liquidated damages are deductible.

Section 214 (a) 2.—DEDUCTIONS ALLOWED: INTEREST.

Section 214 (a) 2, Article 121: Interest. 1–19–50 S–935.

> Interest and taxes paid by a corporation in connection with the construction of its original plant are deductible from its gross income under the Revenue Act of 1913, even though such payments are properly chargeable to capital account and are so charged by the corporation on its books, provided the corporation amends its returns so as to exclude the interest and taxes so deducted from capital account.

The X Co. raises the question as to whether interest and taxes which are paid by a corporation in connection with the construction of its original plant and which have been treated by it as capital expenditure are deductible under the Revenue Act of 1913.

Paragraph G (b) of that Act permits a corporation to deduct from gross income inter alia the following:

> Third. The amount of interest accrued and paid within the year on its indebtedness.
>
> Fourth. All sums paid by it within the year for taxes.

Provisions substantially similar to the above as far as this case is concerned are to be found in the Revenue Acts of 1909 and 1916.

In S–23 it was held that certain items of interest appearing in the property account of a corporation were not deductible as interest paid during the year under the Revenue Acts of 1909, 1913, or 1916. It was pointed out that the provisions in these laws as to the deductibility of interest are not mandatory but permissive, and that, therefore, a taxpayer may elect whether or not he will deduct items of interest. The conclusion of the opinion is, in effect, that by having treated interest as a capital expenditure on its books, the taxpayer had waived the right to claim it as a deduction.

In Law Opinion 530 the question for decision was whether interest paid by a corporation on money borrowed for the purpose of constructing a dam as an addition to its original plant, and treated by the corporation as a capital expenditure, was deductible as interest under the Revenue Act of 1909. It was held that since the dam was merely an addition to an established plant, the interest was improperly charged to capital account, and that for this reason it might be deducted by the taxpayer, notwithstanding the fact that he had treated it as a capital expenditure and not as an operating expense. It was recognized, however, that the taxpayer could not deduct the interest and at the same time claim it as an addition to capital investment, and accordingly the rule laid down was qualified by the statement that in order to be entitled to the deduction the claimant must amend its returns so as to exclude from capital account the interest sought to be deducted.

In S–334 the question was raised as to whether these two opinions were in conflict, and it was held that they were not, the distinction being that the interest involved in S–23 was properly chargeable to capital, while that involved in Law Opinion 530 was not properly so chargeable. The present attitude of the bureau, therefore, is to permit interest to be deducted if it is not properly chargeable to capital, even though it has been treated as a capital expenditure by the taxpayer (L. Op. 530), but not to permit it to be deducted if it was properly chargeable to capital and was in fact so charged on the books of the taxpayer. (S–23.)

The present case falls within the rule of S–23. The interest which is here sought to be deducted related to original construction and was undoubtedly a proper capital charge. Furthermore, it was so treated by claimant on its books.

It is concluded, however, that the rule laid down in S–23 is erroneous and ought not to be followed. The statute provides in unequivocal language that interest paid during the year may be deducted from gross income. S–23 attempts to construe this provision as not applying to interest which is properly chargeable to capital account and is so charged by the taxpayer. No such conditions are to be found in the statute. As far as the face of that instrument is concerned, all a taxpayer need show in order to establish the deductibility of interest (omitting certain limitations not pertinent here) is that it accrued and was paid during the year. Nothing is said or intimated to the effect that the privilege is at all dependent upon whether or not the interest happens to be properly chargeable to capital. Nor is there any justification in the statute for the view that the privilege may be lost by reason of the treatment of interest on the books of the taxpayer. Not only is the provision in question silent as to this feature, but it is significant that where Congress has intended the deductibility of items to be dependent upon bookkeeping entries, it has said so. (See the provisions as to charging off bad debts, Revenue Act of 1913, Par. B; Revenue Act of 1916, sec. 5 (A) (sixth); Revenue Act of 1918, sec. 214(a) (5); and the provisions as to charging off losses; Revenue Act of 1916, sec. 12 (a) second.) Furthermore, it has been held in several cases that bookkeeping entries are not conclusive in the face of facts and that they can not operate to stop a taxpayer from disclosing the true state of his affairs. (Doyle *v.* Mitchell Brothers, 235 Fed. 686, affd. 247 U. S. 179; Forty Fort Coal *v.* Kirkendall, 233 Fed. 704; Baldwin Locomotive Works *v.* McCoach, 221 Fed. 59.)

In short, the statute permits interest to be deducted, and interest is interest whether carried as a capital charge or an operating expense.

What has been said with respect to interest paid by claimant is equally applicable to taxes. The provision as to deducting taxes is as unequivocal as that relating to interest and contains no requirement that taxes in order to be deducted must be operating expenses or that they must be so treated on the books of the taxpayer.

The rule herein stated is, of course, subject to the qualification that claimant can not retain the interest or taxes in its capital account if it is permitted to deduct such items from its gross income.

It is, accordingly, held that interest and taxes paid by a corporation in connection with the construction of its original plant are deductible from its gross income under the Revenue Act of 1913, even though such payments are properly chargeable to capital account and are so charged by the corporation in its books, provided the corporation amends its returns so as to exclude the interest and taxes so deducted, from capital account. (Overruling S-23.)

Section 214 (a) 2, Article 121: Interest. 1-19-57.
O. D. 40.

Interest paid or accrued on indebtedness incurred to purchase notes of the Victory Liberty loan is an allowable deduction for income tax purposes.

Section 214 (a) 2, Article 121: Interest.

(See 1-19-40; sec. 213, Art. 80.) Basis of computation of exempt interest on Liberty loan bonds.

Section 214 (a) 3.—DEDUCTIONS ALLOWED: TAXES.

Section 214 (a) 3, Article 131: Taxes. 1-19-58.
O. D. 41.

The 10 per cent tax which is imposed on corporations' undistributed net income by section 10 (b) of the Revenue Act of 1917 is not an allowable deduction from the gross income of a corporation shown on an income tax return.

Section 214 (a) 3, Article 131: Taxes. 13-19-418.
(Also Section 234, Article 561.) O. D. 240.

Additional excise taxes assessed against a corporation under the Revenue Act of 1909 and paid during subsequent years are allowable deductions from the gross income reported on the corporation's return for the year in which paid; but income taxes assessed under the Revenue Acts of 1913 or 1916 are deductible only if paid prior to January 1, 1917.

Section 214 (a) 3, Article 131: Taxes. 22–19–535. O. D. 287.

An individual may claim as a deduction the amount of war tax paid on facilities furnished by public utilities, which include tax on railroad and steamship fares, and the war tax paid on admissions and dues. The war excise taxes imposed by section 904 and paid by the purchaser are deductible, but the war excise taxes imposed by section 900, which are levied against and paid by the manufacturer, producer, or importer, are not deductible by the individual purchaser.

Section 214 (a) 3, Article 131: Taxes.

(See 26–19–593; sec. 222, art. 381.) Deduction of income and war profits taxes paid to a foreign country on income from sources within the United States.

Section 214 (a) 3, Article 132: Federal duties and excise taxes. 4–19–216. O. D. 137.

Wholesale liquor dealers who exercised their option of including excise taxes in cost of merchandise in calculating inventory may not now amend such inventory and treat the taxes as business expenses.

Section 214 (a) 3, Article 133: Taxes for local benefits. 24–19–560. T. D. 2937.

ASSESSMENTS FOR DRAINAGE.

Article 133 of Regulations 45 is hereby amended to read as follows:

ART. 133. *Taxes for local benefits.*—So-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to the property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and when it is clear that the assessments are so limited, the amounts paid thereunder are not deductible as taxes. When assessments are made for the purpose of maintenance or repair of local benefits, the taxpayer may deduct the assessments paid as an expense incurred in business, if the payment of such assessments is necessary to the conduct of his business. When the assessments are made for the purpose of constructing local benefits, the payments by the taxpayer are in the nature of capital expenditures and are not deductible. Where assessments are made for the purpose of both construction and maintenance or repairs, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation can not be made, none of the amounts so paid is deductible.

Section 214 (a) 3, Article 133: Taxes for local benefits. 24–19–561. **(Also Section 234, Article 561.)** O. 928.

Taxpayers should be required to show, in their income tax returns, the nature of assessments paid under the Illinois drainage laws, inasmuch as such laws provide both for special assessments for benefits and for general taxation, depending in some instances upon ordinances promulgated by the trustees of drainage districts.

Article 133 of Regulations 45 provides:

Assessments under Illinois laws relating to drainage districts are not limited to the property benefited, and assessments so paid are deductible.

See also article 561 of Regulations 45.

The above regulation is based upon sections 214 (a) (3) (c) and 234 (a) (3) (c) of the Revenue Act of 1918, which are to the same effect, as follows:

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

(3) Taxes paid or accrued within the taxable year (c) by the authority of any State or Territory, or any county, school district, municipality, or other taxing subdivision of any State or Territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed.

The regulation above quoted is based upon Law Opinion 644, which purports to review the methods of raising funds under the Illinois drainage laws. A closer examination of the Illinois statutes, however, discloses that the conclusion reached in said opinion should be limited to the act of the Illinois Legislature, approved May 17, 1907 (pars. 4326 et seq., Jones & Addington, Ill. Stats. Anno.). There are now in force, however, in addition, the following acts relating to drainage:

The act of May 29, 1889, as amended by the act of May 13, 1901, relating to sanitary drainage districts; the act of May 29, 1879, known as the "Levee act"; the farm drainage act of June 27, 1885; and the act of June 23, 1883, providing for county ditches. The first of these (act of May 29, 1889, as amended) provides for both special assessment and general taxation, while the remainder provide only for special assessments for benefits. (See J. &. A., Ill. Stats. Anno.)

Special assessments for benefits are not deductible as taxes. See Solicitor's Memoranda 231, 231-A, 387, and 823. Taxes that are deductible are those which are levied for the general public welfare by the proper taxing authorities at a like rate against all the property in the territory over which such authorities have jurisdiction. Inasmuch, therefore, as Law Opinion 644, in holding that assessments under the Illinois drainage laws are deductible as general taxes, permits a deduction in some cases where such deduction is not legally sanctioned, it is hereby modified as above indicated, and it is recommended that article 133 of Regulations 45 be amended by striking out all reference to the Illinois drainage laws.

Taxpayers should be required to show, in their income tax returns, the nature of assessments paid under the Illinois drainage laws, inasmuch as such laws provide both for special assessments for benefits and for general taxation, depending in some instances upon ordinances promulgated by the trustees of drainage districts.

Section 214 (a) 3, Article 134: Inheritance taxes. 24-19-562.
T. D. 2933.

This decision confirms and supports the ruling contained in article 134 of Regulations 45.

INCOME TAX—DECISION OF THE UNITED STATES DISTRICT COURT.

1. The tax imposed by the laws of New York upon the transfer of property by will or under the intestate laws is not deductible in ascertaining the taxable net income of the legatee or distributee under the act of October 3, 1913. It is not a "tax," within the meaning of the provision permitting the deduction of "all National, State, county, school, and municipal taxes paid within the year." (Sec. II, par. B.)

2. A tax upon the right to receive an interest in the estate of a decedent is not a charge either against the person receiving the interest or the property or right accruing to him. The legatee or distributee merely receives the balance due after payment of the tax. He does not receive the entire interest, and then pay the tax; and he is consequently not entitled to deduct the amount as a tax paid by him.

UNITED STATES DISTRICT COURT. NO. 501.

Elizabeth S. Prentiss *v.* Mark Eisner, collector of internal revenue.

AUGUSTUS N. HAND, District Judge: This is a demurrer to a complaint whereby the plaintiff seeks to recover income taxes for the year 1913, paid under protest. The objection urged is that the commissioner refused to allow as a deduction transfer taxes which were paid to the State of New York on December 12, 1913, upon an inheritance which vested June 25, 1913.

Paragraph B, Section II, of the act of October 3, 1913, provides:

"That in computing net income for the purpose of the normal tax there shall be allowed as deductions * * * third, all National, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits; * * * ."

The Commissioner of Internal Revenue has ruled that:

"A collateral inheritance tax levied under the laws of the State of New York being, as it is, a charge against the corpus of the estate, does not constitute such an item as can be allowed as a deduction in computing income-tax liability to either the estate or a beneficiary thereof."

The plaintiff contends that the New York transfer taxes are excise taxes imposed by the State upon the right to receive an interest in a decedent's estate, and as such are within the deductions allowed by statute. The Government, on the other hand, says that these taxes are an appropriation by the State of a portion of the decedent's estate before the remainder vests in the legatee. This latter contention is in accordance with the decision in United States *v.* Perkins (163 U. S., 625), where the court said at page 630:

"The legacy becomes the property of the United States only after it has suffered a diminution to the amount of the tax and it is only upon this condition that the legislature consents to a bequest of it."

This decision, which, so far as I know has not been questioned, can not be reconciled with any theory that the tax is refused a right of succession already vested in the legatee.

At the outset we have the important fact that property inherited or transmitted by will is not treated as income in the income-tax act, but, on the contrary, is not only not included, but specifically exempted. In other words, in the hands of a legatee, devisee, heir, or distributee such property is capital and not income. Under these circumstances, it would seem inconsistent with charges against this capital, which accrued prior to, or simultaneously with, the devolution of it could be deducted in income-tax returns. Notwithstanding this, the language of the act would apparently make the transfer taxes a necessary deduction if they are charges against the person receiving the property, or against either the property or the right accruing to him.

The cases are extremely confused and their reasoning is unsatisfactory. It is admitted by them all that the tax is not upon the property itself which is transmitted. To avoid the unconstitutionality of a direct tax upon the property itself which was not apportioned among the States, the Court of Appeals of New York said as to the Federal tax of 1898, in matter of Gihon (169 N. Y., 443): "* * * the full amount of the legacy is in law paid to the legatee and the deduction made from it and paid to the State or Federal Government is paid on account of the legatee from the legacy which he receives."

It is argued that the personal liability of the executor or administrator under the New York law for the payment of the tax makes the view taken by the foregoing case erroneous, but, as Judge Cullen there said, the obligation of the executor or administrator to pay the tax is a mere rule of administration to insure its payment, and not proof that the tax is either on the right to transmit or upon the property itself.

I do not think it follows because the right to transmit or the right to receive the property of a decedent is a privilege granted by the State, and not a common right, that the tax is imposed upon either right. Judge Gray's statement in matter of Swift (137 N. Y., 77) is an accurate description of what occurs:

"What has the State done, in effect, by the enactment of this tax law? It reaches out and appropriates for its use a portion of the property at the moment of its owner's decease; allowing only the balance to pass in the way directed by the testator, or permitted by its intestate law."

To say that the legatee, devisee, heir, or distributee receives the property without any deduction and then pays the tax is really a most artificial way of viewing the transaction. In the case of personal property he really only gets the balance with a credit as a matter of convenient bookkeeping to the amount of the tax. In the case of real estate he receives properly speaking an equity. He can pay the tax and get the land unencumbered or the State can foreclose the lien and he will receive the balance. In either case the only natural way to treat him is as a recipient of a net amount. The condition of the devolution of the property is the receipt of the transfer tax by the State.

In United States *v.* Perkins (163 U. S. 625) the testator bequeathed his property to the United States. The Supreme Court held that the New York transfer tax was upon the testator's right to dispose of his property, and thus sustained the tax, for if it had been treated as upon any right of succession of the United States, the tax could not have been lawfully imposed. This case has been cited with approval in New York decisions both under the old and new transfer tax acts.

I have carefully examined the interesting briefs submitted by counsel and am convinced that the tax can not properly be regarded as an imposition upon either the property or the right to receive a gross amount of the property of a decedent represented by a legacy, devise, or distributive share, but that the property and the right to receive it passed, reduced by the amount of the tax measured by a percentage of the value of the gross share. It is impossible to reconcile the conflicting expressions in judicial opinions, but this treatment of the situation will, I think, accord with the results reached by the various cases. I can see no substantial difference between the New York transfer-tax act in operation in 1913 and the earlier act, and I do not regard any of the acts as imposing a tax upon the plaintiff's right of succession which is deductible in her income tax return.

The demurrer is sustained.

Section 214 (a) 3, Article 134: Inheritance taxes. 13–19–419.
(Also Section 219, Article 341.) O. 812.

The Federal estate tax is not deductible in ascertaining the net income of an estate in process of administration (Rev. Act of 1918, sec. 212 (a), 214 (a) (3), 219 (a) 1).

Opinion is requested as to whether Federal estate taxes paid in the year 1918 should be deducted from the gross income of the estate of a decedent in process of administration in ascertaining the net income of the estate subject to tax.

The statute imposes a tax upon "income received by estates of deceased persons during the period of administration or settlement of the estate" (Rev. Act 1918, sec. 219 (a), par. 1); and provides that net income shall be determined as provided in section 212 (sec. 219(b)). Section 212 provides that net income is to be determined by making the deductions specified in section 214, and the latter section provides for the deduction of "taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war profits, and excess profits taxes," etc. (sec. 214 (a), par. 3).

The answer to the question presented is largely governed by the rule established and the principles applied in Law Opinion 427. The question there considered was the deductibility of State inheritance taxes under the section of the Act of September 8, 1916 (sec. 5 a), third, as amended by sec. 1201 of the Act of Oct. 3, 1917), providing for the deduction of "taxes paid within the year imposed by the authority of * * * any State," etc.

It was held in this opinion that State inheritance taxes laid upon the share received by the individual beneficiary are not deductible under this provision. The gist of the decision is found in this sentence:

> Taxes paid, within the year imposed * * * by the authority of any State," or otherwise, are limited to those imposed upon the taxpayer and do not include taxes paid by him on behalf of another even though he is required by law to make such payment.

The "taxpayer," in the given case, is the estate of a decedent; and it is held that the tax is paid, not by the estate, but by the individual legatee, devisee, or distributee. It is said:

> The true situation is that the full amount of the legacy or distributive share passes from the decedent, but that in the passing "toll" is taken by the State, and the legatee or distributee receives his legacy or distributive share diminished by the amount of the tax. The burden does not fall on the decedent or his estate. The tax is not taken out of the estate. This appears from the fact that it is not chargeable to the entire estate but to the particular legacies and distributive shares subject to the tax.

The ruling is expressly limited to the case of a tax "deductible from the respective legacies or distributive shares."

The question now to be decided is whether the reasoning which led to this decision does, or does not, embrace the present case. If it does, the same result should be reached, even though the facts are, to some extent, different, and the language of the Opinion leaves the question open. The question is, in fact, left open, since the decision is expressly confined to a case in which the tax is imposed upon the individual share of the beneficiary.

The Federal estate tax differs from other taxes in two ways. (a) It is a tax upon the transfer of the entire net estate, not upon any specified legacy, devise, or distributive share. (b) It is, none the less, a tax upon the transfer of the estate, not upon the property transferred (Rev. Act of 1916, sec. 201; Rev. Act, 1918, sec. 401).

It is believed that the latter fact is the controlling one for present purposes, and that the difference first referred to is not material, although special reference is made to it in Law Opinion 427. The present tax, like the one there considered, is imposed upon the transfer of the estate—upon the privilege of transmitting and receiving it—not upon the property composing the estate. The income in question is the income of the estate "during the period of administration or settlement" (sec. 219 (a)). The "estate" from which this income is derived is, of necessity, the property which comes to the executor or administrator to be administered. That is the net estate, remaining after the transfer is complete, and the tax upon the transfer has been liquidated. Thus the "estate"—the taxpayer seeking the deduction—never pays the particular tax in question. No other result is possible without a complete departure from the theory that the tax is laid upon the transfer and not upon the property of the estate.

The foregoing reflects the substance of the transaction, not a mere theory. The tax is a lien upon all the property owned by the decedent, whether real or personal (secs. 402, 409). In cases of intestacy, and in all cases unless a trust arises from an express provision of a will, the real property does not form part of the estate subject to administration; and the income thereof is not part of the gross income from which the deduction is sought. The tax is imposed, however, upon the transfer of the real property just as much as upon the transfer of the personality. Consequently, if the entire estate tax is deducted, we have a deduction which in part has no relation to the income from which it is made. This difficulty could be avoided only by apportioning the tax, and deducting merely the tax upon the transfer of the personal property; but that would plainly be reading into the statute something which it does not contain.

For these reasons it is believed that the decision in Law Opinion 427 governs the present case. The result seems to accord with sound theories of taxation as applied to the facts. The question is, what constitutes a proper deduction from the gross income of an estate in process of administration? The tax under consideration is a charge upon the corpus, and paid out of the corpus. It has not the characteristics of an ordinary tax; that is, of a periodical assessment, having some relation to the current affairs of the taxpayer and the amount of his income. It is an allocation of a part of the entire estate, made once and for all, when the owner dies, as a privilege of transmitting and receiving it. It has no relation whatever to the income of the estate. It is probable that in most cases it exceeds such income, and that its deduction would largely nullify the particular tax in question. Further, and most important of all, it is imposed before the estate, properly speaking, ever comes into existence.

The foregoing rule is contained in Regulations 45 (art. 134), which is hereby confirmed.

It is held, therefore, that the Federal estate tax is not deductible in ascertaining the net income of estates in process of administration.

SECTION 214 (a) 4, 5, 6. DEDUCTIONS ALLOWED: LOSSES.

Section 214 (a) 4, 5, 6, Article 141: Losses. 1–19–51.
O–780.

A loss sustained by an individual from the sale of residential property is deductible in determining net income for purposes of the Revenue Act of 1918 only when the property was purchased or constructed by him with a view to its subsequent sale for pecuniary profit. The intent in purchasing or constructing the property is a question of fact determinable in each case by evidence which should be submitted with the return.

The question is presented whether a loss sustained by an individual in the sale of residential property is deductible from gross income in arriving at his net income for purposes of the income tax imposed by the Revenue Act of 1918.

If such a loss is deductible at all, it is so by reason of the provision contained in subdivision (5) of section 214 (a) of the Act, which provides for a deduction of—

Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business.

The expression "transaction entered into for profit" clearly means a complete business venture from inception to conclusion. The deduction allowed is for losses sustained in any transaction "*entered into*" for profit. The intent to make a profit must have existed at the commencement of the enterprise or the right to deduct losses incurred is not within the contemplation of the statute. To construe the words "transaction entered into for profit" as referring only to the conclusion of the venture—that is, the sale of the property—would result in a practical nullification of the statute.

Few, if any, transactions are "entered into" other than for profit of some kind, but clearly the profit contemplated by the statute is to be pecuniary in character and not simply the pleasure or recreation of the individual, such as his private residence must be to him.

Whether a loss incurred in the sale of residential property is deductible in arriving at net income must be determined by the object or intent of the individual in buying or constructing the property. This is a question of fact and is to be determined, like any other question of fact, by evidence. If the residential property be held by the purchaser out of use or under tenancy and be subsequently sold, there would seem little room for question that the transaction was "entered into for profit" and that the loss, if any, is a proper deduction in determining net income. If, on the other hand, the property is occupied by the purchaser as his home during the whole or a great portion of the period of his ownership, a strong presumption is raised that the property was purchased for his personal use as a residence; that the transaction was not "entered into for profit" within the meaning of the statute. This presumption will not be overcome by his self-serving declaration, uncorroborated, that his purpose was otherwise.

An individual claiming deduction for loss incurred in the sale of residential property should attach to his return an affidavit stating the facts as to the purpose and use of the property in connection with which loss is claimed and his intent in purchasing it, and his affidavit should be supported by other evidence, record if possible, showing his intent when he *entered into* the transaction.

It is held that a loss sustained by an individual from the sale of residential property is deductible in determining net income for purposes of the Revenue Act of 1918 only when the property was purchased or constructed by him with a view to its subsequent sale for pecuniary profit. The intent in purchasing or constructing the property is a question of fact determinable in each case by evidence which should be submitted with the return.

Section 214 (a) 4, 5, 6, Article 141: Losses. 6–19–279.
O–845.

A loss incurred by a corporation through embezzlement is an allowable deduction from gross income for the year in which the embezzlement occurred. Where the embezzlement is not discovered in the taxable year but is later discovered and admitted by the embezzler, a part of the money being promptly recovered, the amount so recovered tends to diminish the amount of allowable deduction on account of the embezzlement for the year in which the embezzlement occurred, and is ordinarily not returnable as income in the year when received. (Solicitor's memorandum 698 modified.)

Opinion has been requested as to the taxability of amounts recovered from an embezzler in 1917 to cover embezzlements extending over a period of several years.

Section 12 (*a*) of the Act of September 8, 1916, as amended by the Act of October 3, 1917, provides:

> In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources * * *.
>
> Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise * * *.

It appears that in the year 1916 a company discovered that the manager of one of its branches had been misappropriating its funds. Subsequent investigation developed the fact that the irregularities extended over a period of a number of years.

It is assumed from the facts as stated that this company was not protected by any fidelity bond. In 1917, the company recovered a portion of the misappropriated funds from the embezzler and the company objects to returning this amount as income for the year 1917, as held by this department. The company contends that the money was actually received in the years in which the same came into the hands of its agent, and therefore constitutes income for those years, notwithstanding the fact that the same was subsequently embezzled by the agent and never entered on the company's books.

Attention is called to the case of United States *v.* Cleveland, Cincinnati, Chicago & St. Louis Railway Co., and decided in the District Court for the Southern District of Ohio, Southern Division, on February 23, 1916. (So far as known the opinion has not been printed in the Federal Reporter or elsewhere.) Prior to 1909, covering a period of several years, the treasurer of the defendant railway company had embezzled a large sum of money, but the embezzlement was not discovered until the year 1909. The defendant claimed a deduction of this amount from its gross income under the Act of August 5, 1909, which, like the present statute, limited the deductions on account of losses to those "actually sustained during the year."

The court said:

> The time of the discovery of a loss bears no relation to the date the loss was sustained. The loss was sustained when the theft occurred, although the defendant did not know at the time of the depletion of its assets. As each embezzlement occurred, the defendant was poorer to the extent of it. It then sustained a loss. One of the definitions of "sustained" is "undergo." As each embezzlement occurred, the defendant underwent the loss of that much money. It is clear that the defendant is not entitled to the deduction claimed.

The loss, therefore, was sustained in the years in which the embezzlement occurred. When a loss by embezzlement is discovered in the same year it is sustained, the taxpayer ordinarily has the right to deduct the whole of the loss of the theft as a loss for that year. This would not be true, however, as to the amount of any such loss which was covered by a fidelity bond, even though collection was not made on that bond during the year in which the loss occurred. The reason for this is that instead of the money which was stolen the taxpayer has a claim against the bonding company which is presumably equivalent to cash. Where there is no fidelity bond, but, within the taxable year in which the loss occurred, part of the sum embezzled is recovered, the amount so recovered may not, of course, be used as a deduction. Where, as in the present case, the taxpayer did not know of the loss until a later year, but immediately on discovering the loss, succeeded in reducing it by securing from the embezzler or his friends a sum of money in partial replacement, such recovery is evidence that at the time the embezzlement occurred, if the taxpayer had known of it, he could have secured the same reimbursement. That is, if it proves possible after a long delay to reduce the amount of the loss, it seems clear that no less sum would have been recovered in reduction of the loss, if action had been taken promptly after the embezzlement. It is worthy of note that the liability of the embezzler was at all times undisputed.

The rule applicable to an amount recovered on account of a debt previously charged off because determined to be worthless is not applicable here.

The conclusion is reached that the taxpayer should amend its returns for the year 1909 or any subsequent years. The sums abstracted by the embezzler did not constitute deductible losses except to the extent that they exceed the sum recovered, the amounts embezzled within that sum being considered as replaced by a collectible and undisputed claim against the embezzler. The sums embezzled in excess of that sum should be allowed as deductions in the year in which the embezzlement actually occurred. Solicitor's Memorandum 698 is modified so far as inconsistent herewith.

Section 214 (a) 4, 5, 6, Article 141: Losses. 30–19–639.
(Also Section 214 (a) 8, Article 170. S–1217.

INCOME TAX, SECTION II, PARAGRAPH G, SUBDIVISION (B), ACT OF OCTOBER 3, 1913.

Deductions for losses for the year 1915 sustained by the M Company as a result of the retirement and salvaging of equipment.

Reference is made to the claim of the M Company for the abatement of additional income tax for the year 1915, assessed under the act of October 3, 1913.

Section II, paragraph G(b), act of October 3, 1913, is in part as follows:

> Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint-stock company, or association, or insurance company received within the year from all sources, * * * (second) all losses sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear, and tear of property, if any. * * *

The facts of the case are as follows: At a meeting of the board of directors of the M Company, the president reported that certain equipment owned by the company was no longer adequate for service, and had therefore been permanently retired. It was thereupon voted that the book value of the equipment be reduced from 26x dollars to x dollars, and that proper entries be made upon the books of the company in accordance with the purpose of this vote.

In making out its income-tax return for the year 1915 the company deducted as a loss the sum of 26x dollars, this amount representing the combined book values prior to July, 1915 (the date of the vote above referred to), of the equipment retired. In computing this loss no deductions were made for depreciation or salvage. Owing to this deduction, the income-tax return of the company for the year 1915 showed no net income. Upon an investigation of the books of the company by internal-revenue agents the loss deducted for the equipment was disallowed. The return thus corrected showed a net income of 9x dollars, upon which a tax of 1 per cent was assessed. The company filed a claim for abatement of this tax. The rate of depreciation used by the company was 4 per cent on the book values of equipment, which was equivalent to 3 per cent on original cost. On the date of retirement, depreciation reserves carried for the equipment amounted to only about 13 per cent of their book values.

The deduction in this case was not a loss within the meaning of section II G(b), act of October 3, 1913. This subdivision of the act provides for the deduction of all losses actually sustained within the year not compensated for by insurance or otherwise. It further provides for a reasonable allowance for depreciation by use, wear, and tear of property, if any. Income-tax return Form 1031 (revised September, 1915), under "Deductions," provides under 5(a) for "Losses sustained," and under 5(b) for "Depreciation." Although depreciation is one kind of a loss, it is not to be confused with losses in general. Depreciation is a gradual loss due to the wearing out of property from use and age, which will eventually necessitate its abandonment or replacement. It varies with different kinds of property, depending on the nature of the property and the use to which it is put. The losses properly deductible under 5(a) of Form 1031 are those sustained in business transactions and from fires, storms, shipwrecks, other casualties, and thefts, but not through the exhaustion, depletion, or gradual wearing out of property.

In the instant case, no loss deductible under 5(a) of Form 1031 appears to have been sustained by the company. The equipment had evidently outlived its usefulness. As a business proposition it was decided to retire it from service and salvage it. If the company had pursued a conservative policy, it would presumably have accumulated a sufficient depreciation reserve to cover the difference between the original cost of the equipment and its salvage value. The fact that in past years it neglected to allow for sufficient depreciation, does not make the resulting discrepancy between the book values of the equipment and its salvage value deductible as a loss within the intent of section II G(b) second, act of October 3, 1913.

Provided an insufficient depreciation allowance was deducted on the equipment in the income returns of the company for the years 1913, 1914, and 1915, to avail itself of a larger deduction for depreciation for such years, it must amend such returns and deduct a reasonable allowance. In such case the burden would be upon the company to show that its depreciation on rate of 4 per cent on book values was not reasonable.

It should be pointed out that in determining the amount of a loss of property for purposes of deduction under section II G(*b*), act of October 3, 1913, it is necessary to deduct from the cost of the property, or its fair market value as of March 1, 1913, if acquired prior thereto, the amount of depreciation since its acquisition, or since March 1, 1913, if acquired prior thereto, and also the total amount of its salvage. If this were done in the instant case, the amount of depreciation on the equipment since March 1, 1913, plus the amount received by way of salvage, should equal its fair market value as of March 1, 1913. If it fell below such fair market value, it would be because insufficient depreciation had been allowed for the years 1913, 1914, and 1915.

The fact that the company may be barred by the five-year limitation provided for in section 252 of the revenue act of 1918 from now claiming a refund for insufficient depreciation deducted in its returns for the years 1913 and 1914 does not alter the fact that it is in this manner that losses in the nature of depreciation must be taken advantage of by way of deduction. The only exception to the above is provided for by Regulations 45, article 170. It would be a human impossibility to estimate absolutely exactly the depreciation upon any given piece of property. When the property is discarded and salvaged, the depreciation allowance plus the salvage value may slightly exceed or fall slightly below the cost of the property. In the case of a gain over cost this must be treated as income. If the depreciation allowance plus salvage falls below the cost, the difference may be treated as a loss. This is for purpose of adjustment and to save reopening the depreciation account. It would not apply in cases like the present where the depreciation allowance had been clearly insufficient. * * *

Section 214 (a) 4, 5, 6, Article 141: Losses. 10–19–357.
T. B. R. 35.

Revenue Act of 1918.—Deductibility of losses resulting from the sale of property acquired by gift, bequest, devise, or descent.

The opinion of the Advisory Tax Board is requested as to whether "the acquisition of property by gift, bequest, devise, or descent and its subsequent sale is a 'transaction entered into for profit' within the meaning of section 214 (a) (5) of the Revenue Act of 1918, and consequently whether a loss sustained in the sale of such property is deductible from gross income under that section of the act."

Section 214 (a) (5), above referred to, permits the deduction from gross income in the case of resident individuals of "losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *."

The question is substantially disposed of by Law Opinion 316 in which the language of section 5 (a) (fifth) of the Revenue Act of 1916 was construed. This section authorized a deduction of losses sustained "in transactions entered into for profit," but unlike the present statute limited such deduction to "an amount not exceeding the profits arising therefrom." Law Opinion 316 provides:

> Executors or administrators are charged with the assets of the decedent at a certain value ordinarily computed as of the date of the death, and it has been properly ruled that they must account in their income return for gains resulting to the estate from disposing of assets at a price higher than such value. Being clearly required to account for such gains, executors and administrators have been permitted to claim the benefit under *clause fifth* of offsetting against such gains any losses sustained by the estate in the same period through the sale of assets at less than the value fixed as of the date of the death. The estate is treated for this purpose as if at the date of the death it has made cash investments in the assets left by the decedent.

The principle herein applied to an estate applies also to any person who acquires property by gift, bequest, devise, or descent. Such person is to be treated for purposes of the income tax as a purchaser of the property at its value at the time of acquisition. and, like a purchaser, must have "entered into the transaction for profit" if he is to be allowed a deduction for loss. A person may, however, as truly enter into a transaction for profit by acquiring property by gift, bequest, devise, or descent as by acquiring property by purchase. In any case it is a question of fact to be determined upon the evidence. Ordinary investment property, whether acquired by purchase or otherwise, is to be treated as having been acquired for purposes of profit unless the conduct of the person acquiring it furnishes evidence to the contrary.

Law opinion 780 is not inconsistent with the view herein stated. It lays down the principle that "the expression 'transaction entered into for profit' clearly means a complete business venture from inception to conclusion," that "the intent to make a profit must have existed at the commencement of the enterprise or the right to deduct losses incurred is not within the contemplation of the statute." The opinion does not suggest that the intent to make a profit may not exist at the time of the acquisition of property by gift, bequest, devise, or descent.

It is held, therefore, (1) that a loss deductible from gross income under section 214(a)(5) of the Revenue Act of 1918 is sustained from the sale of property acquired by gift, bequest, devise, or descent, whenever property so acquired is as a matter of fact acquired for purposes of profit, and that ordinary investment property so acquired is to be treated as having been acquired for purposes of profit unless the conduct of the recipient furnishes evidence to the contrary.

Section 214 (a) 4, 5, 6, Article 141: Losses. 18–19–482.
T. B. R. 55.

Revenue Act of 1918.—Deduction for losses in cases where insurance is recovered during a subsequent taxable year.

Section 214(a)(6) of the Revenue Act of 1918 provides that individuals may deduct losses sustained during the taxable year * * * if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise.

By section 234 (a) (4) corporations are permitted to deduct—

Losses sustained during the taxable year and not compensated for by insurance or otherwise.

The earlier acts contained language of substantially the same import.

Under all of these provisions the emphasis is placed, so far as the time of deduction is concerned, upon the word "sustained." The department has consistently held that a loss is properly deductible only in the year in which it occurs. This principle has been applied in cases of damage arising from storms (Solicitor's Memorandum 630), even though it was not possible to determine accurately the amount of the loss until a subsequent fiscal period. In the case of embezzlement it has been held that the amount of the loss must be reduced by the value of any claim against a bonding company or the embezzler.

When a loss by embezzlement is discovered in the same year it is sustained, the taxpayer ordinarily has the right to deduct the whole of the loss of the theft as a loss for that year. This would not be true, however, as to the amount of any such loss as was covered by a fidelity bond, even though collection was not made on that bond during the year in which the loss occurred. The reason for this is that instead of the money which was stolen the taxpayer has a claim against the bonding company which is presumably equivalent to cash. (Law Opinion 845.)

The case of embezzlement by a bonded employee is very analogous to the destruction of insured property, and the same principle should apply in determining the deductible loss. Both are cases of insured losses, deductible under this section of the law, and the determination of the exact amount of the loss prior to its ultimate adjustment may be of equal difficulty.

The fact that in the great majority of cases claims against an insurance company or bonding company are settled promptly and without delay or litigation greatly diminishes the administrative difficulty of applying this rule.

The Advisory Tax Board, therefore, recommends that in those cases in which a loss occurs in one taxable year the taxpayer should compute his loss by deducting from the total loss the estimated amount of the recoverable insurance. The loss so determined should be deducted from the taxpayer's income of the year in which the loss was sustained. If subsequent events demonstrate that this estimate was substantially inaccurate, an amended return should be filed correcting the mistake.

Section 214 (a) 4, 5, 6, Article 141: Losses. 1–19–59.
O. D. 42.

The subletting of an apartment by a tenant on account of being required to make his residence in another city is held not to be a "transaction entered into for profit." Therefore any loss sustained through such transaction is not deductible from gross income.

Section 214 (a) 4, 5, 6, Article 141: Losses. 2–19–149.
O. D. 103.

If a taxpayer makes an actual bona fide sale of securities at a loss in 1918, the loss is deductible even though the taxpayer repurchases the securities in the succeeding year at the same price for which they were sold. However, the burden of proof will be on the taxpayer to show that the sale was not fictitious.

Section 214 (a) 4, 5, 6, Article 141: Losses. 4–19–218.
O. D. 138.

Section 214(a) 5, Revenue Act of 1918, does not contemplate that a distinction shall be made between an investment in property or securities with the object of deriving an income from the capital employed, and an investment which is made for the purpose of realizing a profit on the resale of the property or securities purchased.

Section 214 (a) 4, 5, 6, Article 141: Losses. 6–19–273.
O. D. 165.

A loss incurred through embezzlement is an allowable deduction from gross income for the year or years in which the loss was actually sustained. The amount of such loss should be reduced by the reasonable value of any claim against the embezzler or his sureties which can fairly be said to have an ascertainable value, such as a claim against a surety company.

Section 214 (a) 4, 5, 6, Article 141: Losses. 13–19–420.
O. D. 241.

Where a person purchases bonds for another, guaranteeing said bonds against any loss, and a loss occurs due to subsequent insolvency of the corporation issuing same, and the guarantor makes good the loss, the same is not deductible within the meaning of section 214, article 141, of the Revenue Act of 1918, unless such loss occurs in trade or business or in a transaction entered into for profit.

Section 214 (a) 4, 5, 6, Article 143: Loss of useful value. 2–19–150.
O. D. 102.

No deduction representing extraordinary loss due to prohibition legislation is allowable in the case of vineyards unless such legislation necessitates the abandonment of the vineyard. If the vineyard is abandoned, the amount deductible as a loss is the cost of the vineyard, or its fair market value as at March 1, 1913, if acquired prior to that date, plus cost of subsequent improvements, less any depreciation previously charged off and any salvage value. No deduction is permitted on account of land. If, by reason of legislation passed in 1918, the abandonment of the vineyard occurs in 1919, the loss deduction may be equally divided between 1918 and 1919, since the law prohibits the utilization of the 1919 crop, and 1919 income is to be attributed to the manufacture and sale of vintage of 1918 and earlier years.

Section 214 (a) 4, 5, 6, Article 143: Loss of useful value.

(See 3–19–190, sec. 214 (a) 8, art. 162.) Taxpayers with plant manufacturing beer bottles, not adapted for any other purposes, is entitled to a deduction for obsolescence.

Section 214 (a) 4, 5, 6, Article 144: Shrinkage in securities and stocks. 9–19–341.
T. D. 2882 (1).

Insurance companies owning securities taken at market value may not, under section 38 of the Act of August 5, 1909, deduct from gross income as depreciation the net decrease in market value of such securities.

Section 38 of the Act of August 5, 1909, after imposing on insurance companies a special excise tax with respect to the carrying on or doing business equivalent to 1 per cent upon the net income over and above $5,000, exclusive of certain stated amounts, provides that such income shall be ascertained by deducting from the gross amount of the income received within the year from all sources "all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any."

The question has been considered whether insurance companies which own securities taken at the market value may deduct from gross income as depreciation the net decrease in market value of such securities.

The only deduction appropriate, of those allowed by section 38 of the Act of August 5, 1909, is that quoted above. The quoted clause undoubtedly goes to a depreciation which has not yet been realized by sale of the depreciated property; it was not intended to cover a loss resulting from an actual sale of the securities, but is limited to the loss in actual use value due to wear and tear, reflected in a fall in money value. The fluctuations in the market value of a commercial security, as in the case of a stock of goods, are constant from month to month, but no one regards them as a final depreciation in value from which the property will not recover. In order to be a loss "actually sustained" there must be a certain deterioration of those elements which contribute to the beneficial use of the property and which prevent it from ever commanding the same opinion of its value as before. The statute refers only to such goods as by reason of their physical deterioration are permanently impaired in use, from which impairment there is no chance of recovery. It is therefore held that an insurance company may not deduct from its gross income as depreciation the net decrease in market value of securities taken at market value during the year.

Section 214 (a) 4, 5, 6, Article 144: Shrinkage in securities and stocks. 11–19–378. O. D. 216.

The surrender of stock for the purpose of wiping out an operating deficit can not be made the basis of a deduction in the returns of the individual stockholders.

Section 214 (a) 4, 5, 6, Article 144: Shrinkage in securities and stocks.

(See 11–19–383; sec. 219, art. 343.) The rule that no deduction can be claimed on account of shrinkage in the value of property owned by a taxpayer is applicable where the return is filed by the administrator of the estate for a decedent.

Section 214 (a) 4, 5, 6, Article 144: Shrinkage in securities and stocks.

(See 24–19–558; sec. 212, art. 23.) Accrued losses from "short sales" of stock.

Section 214 (a) 7.—DEDUCTIONS ALLOWED; BAD DEBTS.

Section 214 (a) 7, Article 151: Bad debts. 24–19–564. O. D. 297.

The difference between the face value of a note and the amount received in compromise is an allowable deduction, provided the debtor has no assets out of which the entire amount may be collected by suit. However, where the debt is compromised and the debtor has assets out of which the entire debt could have been collected through legal action, the difference between the amount received in compromise and the amount claimed, whether admitted or disputed, can not be allowed as a bad debt.

Section 214 (a) 8.—DEDUCTIONS ALLOWED; DEPRECIATION.

Section 214 (a) 8, Article 161: Depreciation. 8-19-320.
O-862.

Deductions in the case of wine vineyards rendered obsolete by prohibition legislation; obsolescence.

The question is presented as to the deduction allowable for obsolescence in the case of vineyards whose usefulness is impaired or destroyed, in whole or in part, by prohibition legislation.

The Revenue Act of 1918, approved February 24, 1919, provides (sec. 214(a)):

> That in computing net income there shall be allowed as deductions:
>
> * * * * * * *
>
> (8) A reasonable allowance for the exhaustion, wear, and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

and in section 234(a):

> That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * * * *
>
> (7) A reasonable allowance for the exhaustion, wear, and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

It is represented that certain vineyards are seriously affected by prohibition legislation; that by reason of the character of the grapes which they produce the owners have been unable up to the present time to find a market to replace that which prohibition laws are about to destroy; that while in some instances there may still be an opportunity to use, for wine-making purposes, the crop of the year 1919, in many cases the opportunity for making wine is already passed; that experiments are now being conducted in the hope of finding a way to utilize the particular variety of grapes here considered so that it will not be necessary to abandon the vineyards; and that in view of such experiments the vineyards in question have, in many instances, not been junked, but are being cultivated in the hope of finding a profitable use for the crop. It is further represented that in some cases these vineyards will be or already have been abandoned, the vines pulled up, and the land planted to other crops, and that in a few instances, owing to the character of the land or its location, the total abandonment of the vineyards for any purpose may result.

While the Acts of October 3, 1913, and October 3, 1917, were construed to allow a deduction for obsoleteness, demonstrated by the actual junking or abandonment of property, as a deduction in determining the net income of an individual or a corporation, obsolescence, or the gradual becoming out of use, was not recognized as an allowable deduction prior to the Revenue Act of 1918.

Obsolescence—that is, the process of gradually becoming out of use—has long been recognized in the manufacturing world as a material factor in determining the useful life of machinery. It has been a matter of general experience that whereas the physical life of a machine when wear and tear only were considered might be 20 years, yet its useful life in a given employment might be materially shortened by the introduction of improved processes and new inventions, and that where the new processes and inventions were revolutionary its useful life might be reduced to a brief period, the minimum being the time necessary for the manufacture and installation of the new machinery.

The effect of prohibition legislation upon wine vineyards is so closely analogous to that produced by the introduction of revolutionary inventions in manufacturing as to bring it clearly within both the reason and the language of the statute. A reasonable deduction for the obsolescence thus resulting is, therefore, allowable.

Where a vineyard planted to wine grapes continues to be cultivated after the enactment of prohibition legislation in the hope that some new and profitable use for the crop may be found, it now appears that a material loss will be incurred by the owner. The situation, however, is so novel as to render the determination of the amount of the loss impossible at this time, and there is no data available from which to determine the length of time that will be required to ascertain whether such use for the grapes may be found. These elements of uncertainty must be recognized in making any ruling as to the deductions allowable in the case cited and necessitate a departure from the rule heretofore followed that what constitutes a proper deduction is to be determined by the facts existing at the time the loss is incurred and that neither the taxpayer nor the Government can be allowed to amend the return to accord with subsequently ascertained facts. A "reasonable allowance" in advance of actual obsoleteness can only be made by allowing a tentative deduction for obsolescence for the tax year in which the legislation is passed, leaving the definite determination of the loss involved to await the result of the experiment. The deduction allowed by the statute is a "reasonable allowance" which involves a recognition that it must be made on a basis less certain than is required where an actual loss based on previous abandonment is claimed. From a memorandum of the Advisory Tax Board it is learned that the board considers that where abandonment has not occurred and the vineyards are being experimentally cultivated one-half the loss which would result in case of failure to find a profitable use for the grapes produced by the vineyard will be a reasonable tentative deduction upon an obsolescence basis for the tax year in which the prohibition act is passed, it being assumed that two years will be a sufficient period within which to determine the success or failure of the experiment, and this conclusion is regarded as reasonable. Should obsoleteness not ensue within the second year, this allowance will prove to have been too liberal.

Where a vineyard is abandoned for the growing of wine grapes and the vines and improvements incidental solely to such use are junked and the land applied to other uses, there is a definite basis for the determination of the loss. Such loss is represented by the difference between the value of such vines and improvements on March 1, 1913, if previously acquired, or their cost if subsequently acquired, and their salvage or junk value plus any depreciation previously charged off. This loss by obsolescence will be distributed over the period elapsing between the time when the prohibition measure causing it was passed and the year in which abandonment occurs. Any improvements, such as the installation of drainage or irrigation, fencing, breaking up of the ground, or similar improvements, which, although incidental to the planting of the vineyard, tend to permanently improve the land for other uses, are not to be included in determining the value or cost of the property abandoned.

Generally speaking, no allowance for obsolescence or obsoleteness is allowable in the case of land, because deductions for these causes depend upon substantial loss of use, and the presumption is that land which has been useful for one purpose will still be of use for some other purpose. In rare instances, however, this presumption may be overcome by the production of evidence tending to show that after the prohibitory law becomes effective the land will not be commercially profitable for any purpose. Mere decrease in the value of land, of even 40 or 50 per cent, will not be a sufficient basis for an allowance for obsolescence or for obsoleteness. Such decrease in value can be deducted only when realized by sale or in some other manner. The exception here made is in the case of land which not only decreases in value but decreases to so marked a degree that it becomes practically worthless. This decrease must be due to a substantial loss of usefulness of the land through the prohibition legislation, due to the fact that the vineyard land is not susceptible of profitable cultivation in other crops because of the character of the soil or its location. Where the taxpayer has successfully shown that his case is one of the unusual cases in which the land is rendered substantially useless by prohibition legislation, a deduction for obsolescence of the land as well as the vines and improvements is allowable, and in such case it will be proper to include in the cost or value used as the basis of obsolescence the value of any improvements which were regarded as increasing the permanent value of the property and which have not heretofore been treated as an expense.

It is therefore held that:

(1) Where vineyards planted to wine grapes appear to be rendered useless for profitable operation as vineyards through the enactment of prohibition legislation, but the owners continue to cultivate them in the hope that some new and profitable use for the crop may be found, a reasonable deduction for obsolescence may be claimed. There being at this time no data available upon which a determination of what constitutes a reasonable deduction may be made, a tentative deduction of one-half the loss which would result from the total abandonment of the property for vineyard purposes may be made in the return for the year in which the legislation was enacted, subject to adjustment when the success or failure of the experiment shall have been satisfactorily established.

(2) Where vineyards devoted to the growing of wine grapes are, as a result of prohibition legislation, abandoned as vineyards and the vines and improvements incidental solely to grape growing are junked and the land employed in other uses, the loss directly resulting may be deducted in determining the net income of the owner, care being taken to exclude from the deduction the value of any improvements, such as installation of drainage or irrigation, fencing, breaking up of

the soil, and similar improvements which, while incidental to the planting of the vineyard, tend to permanently improve the ground for other uses. The allowance for obsolescence will be distributed over the period elapsing between the passage of the prohibition measure and the date when abandonment occurs.

(3) In general, no deduction for obsolescence or obsoleteness is allowable in the case of land, but in exceptional cases, where the loss of usefulness through prohibition legislation is so great that the land practically becomes worthless, the taxpayer may, upon the proper showing, be allowed a reasonable deduction on that account for the land as well as for the vines and improvements. In this case the cost or value used as the basis of such deduction for obsolescence or obsoleteness may properly include the value of any improvements which when made were regarded as permanently improving the land and which have not heretofore been charged off as expenses. In the case where the entire deduction is claimed in a single year by reason of actual abandonment on account of obsoleteness of land, vines, and improvements, the amount of such deduction will be the difference between the value on March 1, 1913, if acquired prior to that date, or the cost, if acquired on or after that date, and the salvage or junk value, taking into account any deductions or obsolescence previously allowed. Where a reasonable allowance for obsolescence is claimed before actual abandonment, to be spread over a period of two or more years, care must be taken to eliminate from the sum used as the basis of the allowance any general decrease in the value of real estate due to other causes, such decrease being deductible only when definitely determined through sale.

(4) Any return of income from vineyard property in which a deduction is claimed as a result of obsolescence must be accompanied with an affidavit setting forth fully the facts necessary to a determination of the loss properly chargeable to obsolescence under the rules above stated.

(5) Law Opinion 524 and Solicitor's Memoranda 735, 797, and 872 are modified so far as not in accord herewith.

Section 214 (a) 8, Article 162: Depreciable property. 1–19–52. O–797.

ALLOWANCE FOR DEPRECIATION OF ORCHARD TREES.

An owner of an orchard which has reached an income-producing stage is entitled to deduct from gross income in his annual tax returns an annual allowance for depreciation, based upon the capital invested, which comprises the original purchase price of the trees together with the necessary expenditures incurred in bringing them to the producing age, and the rate of depreciation is to be determined by the average life of the trees under normal conditions.

Section 214(a) of the Revenue Act of 1918, approved February 24, 1919, provides:

That in computing net income there shall be allowed as deductions:

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

Corporations are allowed the right to make the same deductions. (Subdiv. (7), sec. 234(a).)

Substantially the same language is contained in the Act of September 8, 1916, as amended by the Act of October 3, 1917. (Sec. 5(a) par. "Seventh"; sec. 12(a), par. "Second.")

Under these provisions of law taxpayers generally are permitted to deduct an annual allowance for depreciation of buildings, and other tangible property used in a trade or business. (See arts. 161, 162, and 163 of Regulations 45, and arts. 4 and 159 of Regulations 33, Revised.) Such yearly allowances are usually computed upon the basis of the cost of the property and the probable number of years constituting its life and they are allowed with a view of returning to the owner tax free an amount equal to the original capital invested.

Just what valid objection there can be in permitting a person who owns an orchard and is in the business of growing fruit to enjoy this same measure of justice does not appear. He plants the young trees and incurs various expenses in caring for them until they reach the producing age. The cost of the trees is to be considered an investment of capital, as is also the expense charged to capital account of bringing them to the point of maturity, where there is an amount of income against which such expenses can be charged.

The life of an orchard may be somewhat indefinite, but it can be as accurately determined as the probable life of a building or other tangible property upon which depreciation charges are allowed. In any event it is certain that there is a gradual and ultimate wearing out of an orchard within a number of years after the productive state has been reached.

It is held, therefore, that all expenditures necessary to bring orchard trees to a producing state should be capitalized and that thereafter a fair and reasonable annual allowance for depreciation should be permitted in order to return to the owner free of taxation the capital invested, just as in the case of an investment in other tangible property used in any other business or trade. The basis of computing the depreciation is the cost of the trees at the time the orchard has reached an income-producing stage, including initial cost and capitalized expenditures incurred in bringing them to maturity, and the rate of depreciation is to be determined by the average life of the trees from the income-producing stage under normal conditions.

Section 214 (a) 8, Article 162: Depreciable property. 7–19–291.
T. B. M. 39.

Application of A to deduct from 1918 income, depreciation and obsolescence on the fair market value as at January 1, 1918, of certain intangible assets should be denied.

The claim of the taxpayer is that depreciation and obsolescence should be allowed to the full amount of the 1918 income; that in arriving at the amount of depreciation and obsolescence the value of the intangible property as of January 1, 1918, and the value as to December 31, 1918, should be taken as the two determining factors.

This claim must be denied. The purpose of all deductions, whether by way of depreciation, obsolescence, depletion, or loss, is to allow a return to the taxpayer of his capital investment without subjecting such capital to income tax. In determining the amount of capital to be recovered without taxation, considerations of practicability must govern. It must, for instance, be capable of measurement by such instruments as are available in the administration of a tax law. This does not mean that other forms of capital do not exist, but merely that a point is reached at which it becomes administratively impracticable to distinguish between capital and income. In such cases the major portion of the annual realization is normally income; therefore the presumption must be adopted that the whole amount is income. Applying this principle to the present case, it will be seen that A through a series of years had by study, training, experimentation, and other means developed a capacity for producing technical devices of a high order. To a considerable extent, however, the expenditures necessary to reach this attainment are of a kind common to all men and are necessary to fit any man to earn a living. Nor is it possible to differentiate between the man of genius and the ordinary man in such a way as to impute a capital investment to the one when it must as a practical matter be denied to the other, for, of course, genius is attributable to gifts of nature more than it is to outlays upon educational or other development.

Even though it were practicable by finer instruments of measurement to reach a capital value of the individual's developed capacity, it would not meet the claim now under consideration, which is, as stated above, that the capital value subject to depreciation and obsolescence as from January 1, 1918, is the market value of the particular device. Such market value on that date would be equal to the discounted value of the anticipated earnings, or, in other words, the capital sum would consist of the income which it is the design of the income tax law to tax. This principle, if applied to property generally, as it would have to be if allowable in the case now under consideration, would not only cripple the present tax law, but in large measure would make all income immune from taxation. The rule that cost in the case of property acquired since March 1, 1913 (except as to gifts and inheritances which are specifically otherwise provided for in the law), rests securely on the ground that capital created by human effort must pass through the door of taxable income before it can for the purpose of that tax establish its position as capital. The law does not tax value appreciation, nor does it recognize value appreciation as capital until such appreciation has been realized and taxed. Neither does the law lay a tax upon the creation of ideas or devices, nor can it without devitalizing itself recognize as capital the value of such mental or material conceptions until after such value has been realized by sale or in such other manner as will first give it the status of taxable income. This step having been taken, the value to the new owner upon which he may claim a capital allowance in computing net income is the cost to him. This is a fundamental in the basis of income taxation, and no exception thereto can be allowed except such as are specifically provided for by the statute.

At the hearing stress was laid upon the provisions of section 214(a) (10) and of section 234(a) (9), which provide that in the case of mines, oil and gas wells, discovered by the taxpayer, the value under certain conditions may be taken as the fair market value of the property at the date of discovery or within 30 days thereafter. This, however, is not a normal rule for the computation of net income, but is an exception specifically granted by the statute and carefully restricted to mines and oil and gas wells. That other kinds of property or other taxpayers may be equally meritorious is immaterial; they are omitted by the statute and can not be brought within it by any proper method of construction.

For the reasons above indicated the Advisory Tax Board recommends that the claim of the taxpayer for a deduction from gross income by way of depreciation and obsolescence based upon the value of his intangible property at January 1, 1918, be denied, and that the amount of each deduction be limited to a reasonable amount based upon the specific cost to him of such property exclusive of all items of such cost which have been deducted as expenses in income tax returns for previous years.

Section 214 (a) 8, Article 162: Depreciable property. 3–19–190.
(Also Section 214 (a) 4, 5, 6, Article 143.) O. D. 125.

Property consisting of a plant, including equipment for the manufacture of beer bottles, which because of restrictions and regulations by the United States Government on the brewery industry can not be sold and in consequence the factory had to be closed, has to the extent the property or plant was constructed for the manufacture of beer bottles and is not suited or adapted for any other purpose without reconstruction, become obsolete. The corporation to that extent is entitled to a deduction for obsolescence. So much of the shrinkage in value of the plant, if any, as is not thus due to obsolescence can not be claimed as a deduction for loss until the property is sold or becomes worthless and the loss is definitely ascertained.

Section 214 (a) 8, Article 163: Depreciation of intangible property. 23–19–545. T. D. 2929.

MODIFICATION OF ARTICLE 163, REGULATIONS NO. 45—DEPRECIATION OF INTANGIBLE PROPERTY.

Article 163, Regulations 45, is modified to read as follows by eliminating therefrom the last sentence reading, "There can be no such allowance in respect of good will, trade names, trade-marks, trade brands, secret formulæ, or processes":

ART. 163. *Depreciation of intangible property.*—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the commissioner.

Section 214 (a) 8, Article 163: Depreciation of intangible property. 15–19–445. T. B. R. 44.

Obsolescence upon intangible assets such as good will, trade-marks, or trade brands may be deducted, within certain definite limitations, in computing taxable net income.

In an office letter to A, it is held that distillers and dealers in liquors are entitled in computing taxable net income to deduct a reasonable allowance for obsolescence of good will, trade-marks, or trade brands, the value of which has been impaired or destroyed by prohibition legislation, such deduction to be computed upon the basis of a period beginning on November 21, 1918, the date upon which the Agricultural appropriation act providing for war-time prohibition was enacted, and July 1, 1919, the date upon which war-time prohibition was to become effective. It was further held (a) that to sustain a claim for a deduction for obsolescence in respect of good will, trade-marks, or trade brands, the taxpayer must show that the value of the property in question has been destroyed or will be destroyed by prohibition legislation, and that the taxpayer is not continuing in any similar trade or business; (b) that an allowance will be made only in respect of such assets as are assignable as distinguished from those attaching to individuals owning or conducting the business, or to the premises at which it is being or has been conducted; and (c) that no allowance for obsolescence will be made in any case where in connection with the operation of his previous business, the taxpayer has developed a good will, trade-mark, or trade brand that will be valuable in continuing a lawful business after prohibition becomes effective.

A has appealed to the Commissioner claiming that the above decision errs in limiting the period over which the obsolescence may be spread from November 21, 1918, to June 30, 1919. He takes the position "That the depletion by obsolescence is the result of the Federal prohibition process, which has been in the course of development * * *;" that although "The trade made substantial apparent profits in 1918" this resulted merely from the liquidating of inventories, and "trade was garnering apparent profits which in reality were only the salvaging of capital * * *;" and urges that if a fixed obsolescence period is to be stated, "The Department conclude that December 18, 1917, the date of the action of the House of Representatives which constituted the final submission of national prohibition to the States, be taken as the point of commencement of the obsolescence."

The question raised, therefore, is whether the period during which the obsolescence may be spread should be limited to that beginning on November 21, 1918, or should be taken as from December 18, 1917, the date upon which Congress submitted the prohibition amendment to the States.

Before considering this question directly, it seems desirable to examine the grounds upon which obsolescence of intangibles, such as good will, trade-marks, trade brands, etc., may be allowed. In the accounting required for tax purposes intangibles, such as good will, trade-marks, and the like are distinguished from tangible property in that in the ordinary case a taxpayer is not required or permitted to make current deductions for depreciation, including in this term ordinary obsolescence. This distinction rests upon the ground that in the ordinary case depreciation of intangibles is too indefinite and uncertain to be reduced to terms of money. In specific instances, however, intangibles may be brought within the rule applicable to tangible property, but only by the force of unusual and controlling circumstances. Article 163 of Regulations 45, for instance, states that "Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance." It is true that this same article states that no such allowance may be made in the case of intangibles of the class now under consideration, and while in general this negative decision is sound, the controlling rule is the one quoted above, and when an item of intangible property falls within that rule it must be dealt with accordingly. The major rule laid down in article 163 is a reasonable extension of the provision of article 143 covering loss of useful value. This article provides "When through some change in business conditions the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in the business, he may claim as a loss for the year in which he takes such action the difference between the cost or the fair market value as of March 1, 1913, of any asset so discarded (less any depreciation allowance) and its salvage value remaining * * *."

The question next arises whether an intangible acquired at a date when its useful life is indefinite may become the subject of a depreciation allowance at some subsequent date at which time the duration of its useful life becomes definitely known. If so, the loss which might be claimed at the end of the life may be spread over the term of the remaining useful life. To hold that no such spread is allowed it is necessary to construe the first sentence of article 163 as meaning that only those intangibles the useful life of which is known at the time of acquisition to be definitely limited in duration may be the subject of depreciation allowance. This seems to be a strained construction, and in the light of article 143 is unnecessarily harsh. The reasonable conclusion seems to be, therefore, that when it is demonstrated that the useful life of an intangible is definitely limited, such intangible then becomes a proper subject of depreciation allowance.

Applying these considerations to the intangibles belonging to distillers and dealers in liquors it is found that such intangibles are subject to depreciation (or obsolescence) during the period in which it is known that their useful life is definitely limited in duration. The determination of this period is, however, by no means easy. Looking backward it can now be seen that prohibition has during recent years had a rapid growth in this country, particularly in the South and in the West. Before the constitutional amendment was adopted some 33 States had prohibition legislation and local option was similarly effective in substantial parts of many of the other States. As early as March, 1913, the Webb-Kenyon Act gave strong indication of a growing sentiment, and this sentiment has since been registered in many other political and judicial expressions.

However clear the general implication of these facts may have been, nothing throughout this course of events was sufficiently explicit and final to fix a period at the end of which the property now under consideration would become valueless. Among these indefinite or incomplete events the submission by Congress of the eighteenth amendment on December 18, 1917, stands out as the most far-reaching and important in the entire chain. The fact that this legislation was adopted in both Houses of Congress by large majorities gave at least some indication of the probable reception of the proposed amendment by the States, and it may, therefore, be granted that at the date of submission there was substantial reason to believe that the amendment would be adopted by the States.

There was, however, no certainty upon this point, and the leaders on both sides of the controversy showed plainly by their actions at the time that neither believed that the issue was settled. Were it not for the facts surrounding the submission of the constitutional amendment, a satisfactory date would be fixed by the adoption of the war-time prohibition act on November 21, 1918. Standing alone this date could be accepted as marking the beginning of the period during which the trade-marks, trade brands, and good will of distillers and dealers in liquors would be completely exhausted. The prohibition amendment, while not finally adopted until after the enactment of war-time prohibition had, however, made such progress that before that date its adoption became a foregone conclusion. The attitude of many States was known, and the formal act of ratification merely awaited the assembling of the legislatures. The trend of sentiment was early shown by the action of several States upon which the distillers and dealers in liquors were counting for success, and which were classed as doubtful by the prohibition forces. Thus in January, 1918, Massachusetts, Maryland, and Kentucky, the first two of which were considered very doubtful by the prohibitionists, voted in favor of the prohibition amendment by a decisive vote. Louisiana, another doubtful State, deadlocked in January upon the amendment, and later in the year ratified. It seems certain that an unprejudiced observer would, in view of the history of the movement and the decisive action taken by these doubtful States in January, have concluded that prohibition was a certain event, which, under the terms of the amendment, would become effective within a year from its final adoption. The conclusion is, therefore, reached that it is reasonable to allow distillers and dealers in liquors to make a deduction in computing net income under the provisions of the Revenue Act of 1918, for any taxable year ending on or after January 31, 1918, and that the end of the period be fixed at the date upon which a taxpayer engaged as distiller or dealer in liquors discontinues such business, such date being in no case later than January 16, 1920, the date upon which prohibition by constitutional amendment becomes effective.

A further question remains for consideration. Upon what basis should the deduction for obsolescence be apportioned between the taxable years ending after January 31, 1918? The statute, sections 214 (a) (8) and 234 (a) (7), provides for a "reasonable" allowance. This places upon the department the burden of laying down rules and regulations defining, so far as may be done, what is "reasonable." In the great majority of cases depreciation is fairly measured by the effluxion of time. This is the ordinary rule, a departure from which should be allowed only when the deduction provided thereunder does not meet the statutory requirement of reasonableness. The use in the statute of the word "reasonable" clearly implied that no rigid rule applicable to all cases can be laid down. Observation of individual cases amply proves that this is true, and therefore when the ordinary rule does not produce a reasonable result, the statute requires that another and a reasonable method be adopted in a particular case or class of cases. The situation presented by the distillers and dealers in liquors is highly exceptional. The total amount in respect of which they are entitled to claim a deduction is the cost of their good will, trade-marks, trade brands, or the value thereof, on March 1, 1913, if acquired prior thereto, excluding, of course, any intangibles acquired since that date, the expenditures for which were deductible in computing income for tax purposes. But as already indicated, the legislative situation had by January 31, 1918, reached a decisive point which completed the first stage in the obsolescence of these assets. On that date a computable part thereof had become obsolete. The value of such assets rests upon the probable future income that will accrue to the owner thereof. Estimates of the probable amount of this income may vary, but there is no other known method by which the value can be computed. In view of the status of prohibition legislation on January 31, 1918, it is certain that upon that date the value of the good will, trade-marks, trade brands, etc., of distillers and dealers in liquors was reduced to the then present value of the income to be derived therefrom between that date and approximately January, 1920. Whatever this value might be in a given case, it would be different from, and probably much less than, the value on March 1, 1913. Had prohibition been immediately effective, instead of becoming operative at a future date, these taxpayers would have been entitled to deduct from gross income of any taxable period ending on or after January 31, 1918, the entire amount of such intangibles.

Depreciation of intangibles now in question when computed upon the basis of the time rule does not meet the requirements of the statute, and therefore another rule must be found. For some purposes apportionment based upon the relative profits of two or more taxable periods provides a proper method, but this rule is obviously inapplicable to the cases now under consideration. The rule of apportionment which most closely approximates the actual facts, and is therefore the most reasonable, is that under which the value of the intangibles on January 31, 1918, is spread on the time basis between that date and the date upon which prohibition became effective and the balance of the allowable deduction (measured by the difference between the value on January 31, 1918, and March 1, 1913), taken in accordance with the provisions of section 205 of the act and articles 1621–1625 of Regulations 45 against the first taxable year ending on or after January 31, 1918.

It is, therefore, the opinion of the Advisory Tax Board (1) that distillers and dealers in liquors are entitled to make a deduction (based upon actual cost or fair market value as at March 1, 1913) from gross income, on account of depreciation or obsolescence of their intangibles, such as good will, trade-marks, trade brands, etc., such deduction being limited to assignable assets, the value of which has been destroyed by prohibition legislation, and (2) that in arriving at the taxable income for the first taxable year ending on or after January 31, 1918, the obsolescence fully accrued on that date is to be allowed as a deduction in computing the income subject to taxation under the revenue act of 1918, plus a further deduction of such proportion of the remaining value of the intangible assets as the interval between January 31, 1918, and the end of the taxable year bears to the total interval between January 31, 1918, and January 16, 1920 (unless at an earlier date the taxpayer discontinues his business, in which case such earlier date shall mark the close of the period), and (3) that for any taxable year following the taxable year just referred to a deduction in respect of the value of such intangible assets on January 31, 1918, based upon a ratable distribution, will be permissible.

Section 214 (a) 8, Article 163: Depreciation of intangible property. 24–19–565. O. D. 298.

Deductions from gross income on account of depreciation or obsolescence of intangibles, such as good will, trade-marks, and trade brands, allowed distillers and dealers in liquors, are also applicable to brewers.

Section 214 (a) 8, Article 163: Depreciation of intangible property. 30–19–640. O. D. 344.

Depreciation of intangible property as explained in article 163 of Regulations 45 applies to all intangible property including patents and copyrights, whether acquired for cash, other property, or corporate stock. The term "capital outlay" includes corporate stock.

Section 214 (a) 8, Article 164: Capital sum recoverable through depreciation allowances. 21–19–524. O. D. 283.

Replacement value of property can not be substituted for the cost of the property as the cost of replacement at a time some years in the future is a speculative figure which can not be used as a basis for determining an annual depreciation charge. The depreciation charge will replace the amount of the original capital outlay, which may be more or less than adequate to replace the item to which it applies. If less than adequate, new capital must be provided from surplus or otherwise to effect the replacement.

Section 214 (a) 8, Article 167: Depreciation of patent or copyright. 20–19–506. T. B. R. 59.
(Also Section 326, Article 845.)

REVENUE ACT OF 1916 AS AMENDED AND REVENUE ACT OF 1917.

(1) Depreciation of patents acquired prior to March 1, 1913, should be taken on the basis of their fair market value as of that date, if affirmative and satisfactory evidence of such value is offered.

(2) Invested capital of a corporate taxpayer for the year 1917 should be reduced by the amount of its income tax for the year 1916 as of the date upon which such tax became due and payable.

(1) The taxpayer owned certain patents on March 1, 1913, which, according to its claim, had a value on that date much larger than their original cost. The Income Tax Unit ruled that the taxpayer was entitled to deduct depreciation on the basis of the actual cost of such patents and not on the basis of their fair market value on March 1, 1913, and the taxpayer appealed.

Regulations 33 (revised), article 174, adopted under the Revenue Act of 1916 as amended by the Revenue Act of 1917, provides:

In determining the amount deductible on account of the expiring life of patents, only the actual cost thereof and not an estimated value as of March 1, 1913, or any other date, will be considered. (See also art. 113.)

Article 167, Regulations 45, adopted under the Revenue Act of 1918, provides:

In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost (not already deducted as current expenses) of the patent or copyright or its fair market value as of March 1, 1913, if acquired prior thereto; * * *

Depreciation of a patent can be taken on the basis of the fair market value as of March 1, 1913, only when affirmative and satisfactory evidence of such value is offered. (See also articles 161, 163, and 164.)

The statutory bases for these deductions are found, respectively, in the provision in the earlier act authorizing the deduction from gross income of certain "losses" "including a reasonable allowance for the exhaustion, wear, and tear of property arising out of its use or employment in the business or trade" (Revenue Act of 1916, sec. 12(a) Second.) See also sec. 106, last paragraph, and in the provision in the latter act authorizing the deduction from gross income of "a reasonable allowance for the exhaustion, wear, and tear of property used in the trade or business, including a reasonable allowance for obsolescence." (Revenue Act of 1918, sec. 234(a) (7). See also sec. 202 (a) (1)).

The Advisory Tax Board does not find in these or in any other statutory provisions adequate reason for concluding that there is a difference in the law with respect to the allowance for depreciation of patents acquired prior to March 1, 1913, in the year 1917 under the Revenue Act of 1916 as amended, and in the year 1918 under the Revenue Act of 1918. It is of opinion, moreover, that in this respect the rule laid down in Regulations 45, article 167, is correct and should be applied in the determination of net income for the year 1917, article 174 of Regulations No. 33 (revised) being changed, if necessary, as to which no opinion is expressed, to conform thereto. It follows that the taxpayer's depreciation allowance should be based upon the fair market value of its patents on March 1, 1913, provided it offers affirmative and satisfactory evidence of such value. Neither the question as to what that value was, nor the evidence upon which that question can be determined, is before the Advisory Tax Board.

(2) The Income Tax Unit ruled that the income tax of the taxpayer for the year 1916, payable in the year 1917, should be considered as a reduction of its invested capital as of the date upon which such tax became due and payable. This ruling was correct upon the authority of Treasury Decision 2791. The same rule applies to the Revenue Act of 1918. (See Regulations 45, art. 845.)

It is held therefore (1) that the taxpayer should be allowed depreciation of patents on the basis of their fair market value as of March 1, 1913, if affirmative and satisfactory evidence of such value is offered, such changes, if any, as are necessary being made in Regulations No. 33 (revised), article 174, and (2) that the ruling of the Income Tax Unit that the invested capital of the taxpayer for the year 1917 should be reduced by the amount of its income tax for the year 1916 as of the date upon which such tax became due and payable, is correct.

Section 214 (a) 8, Article 170: Closing depreciation account.

(See 30–19–639; sec. 214 (a) 4, 5, 6, art. 141.) **Adjustment of depreciation and gain or loss when equipment is retired from use.**

Section 214 (a) 9.—DEDUCTIONS ALLOWED: AMORTIZATION.

Section 214 (a) 9, Article 181: Scope of provision for amortization.

(See 15–19–452; sec. 326, art. 840.) Effect on invested capital of amortization deducted under the munitions manufacturers' tax law.

Section 214 (a) 9, Article 181: Scope of provision for amortization.

(See 26–19–597; sec. 301, art. 715:) Amortization when part of income is from Government contracts.

Section 214 (a) 9, Article 182: Property of which may be amortized.

(See 16–19–464; sec. 234, art. 561.) Equipment for manufacture or production of sugar.

Section 214 (a) 9, Article 184: Cost which may be amortized. 5–19–249. T. D. 2859.

The paragraph numbered (3) in article 184 of the final edition of Regulations 45 which reads as follows:

(3) In the case of other property the basis is the estimated reproduction cost as of April 1, 1919, of such property in its then condition. In the final determination such cost will be ascertained under stable postwar conditions, without reference to such date.

is hereby amended to read as follows:

(3) In the case of other property the basis for amortization calculation shall be the estimated value of the property to the taxpayer in terms of its actual use or employment in his going business, such value in no case to be less than the sale or salvage value of the property, provided, however, that in no case shall the preliminary estimate (for purposes of returns to be made in 1919) of the amount of such amortization exceed 25 per cent of the cost of the property. In the final determination the amount of the amortization allowance will be ascertained upon the basis of stable postwar conditions under regulations to be promulgated when these conditions become apparent.

Section 214 (a) 9, Article 187: Redetermination of amortization allowance. 31–19–646. A. R. M. 10.

In re: The interpretation of that part of section 214 (a) 9, providing for amortization which reads as follows: "At any time within three years after the termination of the present war, the Commissioner may, and at the request of the taxpayer shall, reexamine the return and, if he then finds as the result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by Title III for the year or years affected shall be redetermined."

The Committee is of the opinion that Congress in using the phrase "at any time within three years after the termination of the present war" intended to place a limitation only upon the *latest* date before which the contemplated redetermination and adjustment of amortization provided for in the act must be made and that it was not the purpose of Congress to place a limit upon the *earliest* date at which such redetermination and adjustment might be undertaken. Authorities in the use of words agree in assigning to the word "within" a meaning equivalent to "not longer in time than," and it is believed that it is in this sense that the word was here used by Congress and that the phrase is to be construed as equivalent to "at any time *before the expiration of* three years after the termination of the present war." Used in this sense, there is no limitation upon the earliest date at which the redetermination may be undertaken; and this is a reasonable construction to place upon this clause for, obviously, there can be no purpose in delaying such redetermination until after the official proclamation of peace has been issued and the war formally terminated, provided that all the elements now exist and are ascertainable upon which to base such a redetermination. Indeed, the earlier such matters can be and are disposed of, the better will justice be served as between the Government and the taxpayer, for the reason that, all other things being equal, the factors entering into such a redetermination can be more readily and accurately ascertained while all considerations involved are still fresh in the minds and knowledge of those dealing with them than would be likely or possible at a later date.

It is, therefore, the conclusion of the Committee that taxpayers need not await the formal termination of the present war but may present to the Commissioner their claim for a redetermination *at any time prior* to three years after such termination.

Section 214 (a) 10.—DEDUCTIONS ALLOWED: DEPLETION.

Section 214 (a) 10, Article 202: Capital recoverable through depletion allowance in the case of owner. 1–19–53. T. B. R. 4.

Interpretation of clause (c) in articles 202 and 203 of Regulations 45.

The Income Tax Unit has made inquiry as to the interpretation to be placed upon clause (c) in article 202 and also in article 203, Regulations 45, reading as follows: "Deductions for depletion which has or should have been taken to date." Attention is called to the fact that under the 1913 law, the so-called 5 per cent limitation in many cases, particularly in the oil industry, resulted in taxpayers being required to pay a tax on certain sums received which were in effect a return of capital. Similarly, lessees have, under the laws prior to the law of 1918, been denied any depletion in respect of the appreciated value of their lease at March 1, 1913, or any subsequent date, such as that of discovery which is now recognized in the Revenue Act of 1918. In such cases certain taxpayers have been placed upon a footing of some inequality amounting (aside from the year 1917, in which year lessees alone were affected) to a tax in 1913, 1914, and 1915, of 1, and in 1916, 2 per cent upon such part of their revenues as was actually a return of capital. Each revenue law from 1913 to date has aimed at the computation of an amount of statutory net income, and upon this amount the tax has been levied, and while the definition of statutory net income has varied in the different Acts, the amount subject to tax in any year is the income computable under the provisions of the Act applicable to the particular year. The War Revenue Act of 1918 allows a reasonable deduction for depletion based upon the cost, or if the property was acquired prior to March 1, 1913, its fair market value on that date, or in the case of certain oil and mining properties the fair market value within 30 days of discovery, and this deduction may be now taken in certain cases by the lessee. This Act, however, does not contain any provision for the correction of hardships or inequalities imposed by the terms of previous statutes, and the computation of taxable net income for 1918 must, therefore, be determined in respect of the income tax law of that year.

For purposes of invested capital it is held (art. 839, Regulations 45) that—

Depletion, like depreciation, must be recognized in all cases in which it occurs. Depletion attaches to each unit of mineral or other property removed, and the denial of a deduction in computing net income under the Act of August 5, 1909, or the limitation upon the amount of the deduction allowed under the Act of October 3, 1913, does not relieve the corporation of its obligation to make proper provision for depletion of its property in computing its surplus and undivided profits.

In accordance with the reasons above indicated, it is recommended that the amount recoverable by a taxpayer without liability to tax under the War Revenue Act of 1918, either by way of deduction for depletion or of the return of capital upon the sale of the property, is the cost of the property, its fair market value at March 1, 1913, or within 30 days after discovery, as the case may be, minus the amount of depletion (based upon the same cost or value) actually sustained prior to January 1, 1918, whether or not all of such amount has been allowed for the purpose of computing net income under earlier income tax laws.

Section 214 (a) 10, Article 220: Oil and gas wells. **31–19–647. T. D. 2956.**

Article 220 (a): Discovery—Proven tract or lease—Property disproportionate value.
Article 221: Proof of discovery of oil and gas wells.

Regulations 45 are hereby amended by substituting for articles 220 and 221 as they now stand the following three articles:

Art. 220. *Oil and gas wells.*—Section 214 (a) (10) and section 234 (a) (9) provide that taxpayers who discover oil and gas wells on or after March 1, 1913, may, under the circumstances therein prescribed determine the fair market value of such property at the date of discovery or within 30 days thereafter for the purpose of ascertaining allowable deductions for depletion. Before such valuation may be made the statute requires that two conditions precedent be satisfied, (1) that the fair market value of such property (oil and gas wells) on the date of discovery or within 30 days thereafter became materially disproportionate to the cost, by virtue of the discovery, and (2) that such oil and gas wells were not acquired as the result of purchase of a proven tract or lease.

Art. 220 (a). *Discovery—Proven tract or lease—Property disproportionate value.*—(1) For the purpose of these sections of the Revenue Act of 1918, an oil or gas well may be said to be discovered when there is either a natural exposure of oil or gas, or a drilling that discloses the actual and physical presence of oil or gas in quantities sufficient to justify commercial exploitation. Quantities sufficient to justify commercial exploitation are deemed to exist when the quantity and quality of the oil or gas so recovered from the well are such as to afford a reasonable expectation of at least returning the capital invested in such well through the sale of the oil or gas, or both, to be derived therefrom.

(2) A proven tract or lease may be a part or the whole of a proven area. A proven area for the purposes of this statute shall be presumed to be that portion of the productive sand or zone or reservoir included in a square surface

area of 160 acres having as its center the mouth of a well producing oil or gas in commercial quantities. In other words, a producing well shall be presumed to prove that portion of a given sand, zone or reservoir which is included in an area of 160 acres of land, *regardless of private boundaries.* The center of such square area shall be the mouth of the well, and its sides shall be parallel to the section lines established by the United States system of public land surveys in the district in which it is located. Where a district is not covered by the United States land surveys, the sides of said area shall run north and south, east and west.

So much of a taxpayer's tract or lease which lies within an area proven either by himself or by another is "a proven tract or lease" as contemplated by the statute, and the discovery of a well thereon will not entitle such taxpayer to revalue such well for the purpose of depletion allowances, unless the tract or lease had been acquired before it became proven. And even though a well is brought in on a tract or lease not included in a proven area as heretofore defined, nevertheless it may not entitle the owner of the tract or lease in which such well is located to revaluation for depletion purposes, if such tract or lease lies within a compact area which is immediately surrounded by proven land, and the geologic structural conditions on or under the land so inclosed may reasonably warrant the belief that the oil or gas of the proven areas extends thereunder. Under such circumstances the entire area is to be regarded as proven land.

(3) The "property" which may be valued after discovery is the "well." For the purposes of these sections the "well" is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content of the particular sand, zone or reservoir (limestone, breccia, crevice, etc.) in which the discovery was made by the drilling and from which the production is drawn, to the limit of the taxpayer's private bounding lines, but not beyond the limits of the proven area as heretofore provided.

(4) A taxpayer to be entitled to revalue his property after March 1, 1913, for the purpose of depletion allowances must make a discovery after said date and such discovery must result in the fair market value of the property becoming disproportionate to the cost. The fair market value of the property will be deemed to have become disproportionate to the cost when the output of such well of oil or gas affords a reasonable expectation of returning to the taxpayer an amount materially in excess of the cost of the land or lease if acquired since March 1, 1913, or its fair market value on March 1, 1913, if acquired prior thereto, plus the cost of exploration and development work to the time the well was brought in.

ART. 221. *Proof of discovery of oil and gas wells.*—In order to meet the requirements of the preceding article to the satisfaction of the commissioner the taxpayer will be required, among other things, to submit the following with his return: (a) A map of convenient scale, showing the location of the tract and discovery well in question and of the nearest producing well, and the development for a radius of at least three miles from the tract in question, both on the date of discovery and on the date when the fair market value was set; (b) a certified copy of the log of the discovery well, showing the location, the date drilling began, the date of completion and beginning of production, the formations penetrated, the oil, gas, and water sands penetrated, the casing record, including the record of perforations, and any other information tending to show the condition of the well and the location of the sand or zone from which the oil or gas is produced on the date the discovery was claimed; (c) a sworn record of production, clearly proving the commercial productivity of the discovery well; (d) a sworn copy of the records, showing the cost of the property; and (e) a full explanation of the method of determining the value on the date of discovery or within 30 days thereafter, supported by satisfactory evidence of the fairness of this value.

Section 214 (a) 10, Article 222: Charges to capital and to expense in case of mine. 26–19–589. O. D. 314.

All expenditures by a mining company for prospecting and development for the purpose of enlarging the business or continuing it beyond its present limits must be charged to capital account.

Section 214 (a) 10, Article 228: Capital recoverable through depletion allowance in the case of timber. 1-19-60. O. D. 43.

In the case of timber land acquired prior to March 1, 1913, depletion may be based on the average value on that date of all timber located in a single operation unit. In other words, the average value may be determined independently for each separate operation unit. A separate operation unit should include all timber which should logically be manufactured at a single definite mill site.

Section 214 (a) 10, Article 234: Determination of fair market value of timber. 18-19-483. T. D. 2916.
Section 214 (a) 10, Article 235: Determination of quantity of timber.

Providing for the addition of two new articles, Regulations 45, in regard to the determination of the fair market value and quantity of timber.

The final edition of Regulations 45 is amended by the insertion of two new articles to be known as article 234 and article 235, as follows:

ART. 234. *Determination of fair market value of timber.*—Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the most reliable and accurate information with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, in methods of exploitation, in degree of utilization, etc. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. No rule or method of determining the fair market value of timber property is prescribed, but the Commissioner will give due weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, acutal sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purposes of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, disinterested appraisals by approved methods, and other factors. For depletion purposes the cost of the timber or its fair market value at a specified date shall not include any part of the cost or value of the land.

ART. 235. *Determination of quantity of timber.*—Each taxpayer claiming a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, cords, or other units) of timber reasonably known or on good evidence believed to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, as the case may be. The taxpayer, according to his best knowledge and belief and in the light of the most accurate and reliable information, will estimate the number of units of timber actually present upon the specified date. This estimate will state the number of units which would have been found present by a careful estimate made on the specified date with the object of determining 100 per cent of the quantity of timber which the area would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, additional units of timber are found to be available for utilization as the result of the growth of the timber, of closer utilization of the timber, of the utilization of species of trees not formerly utilized, of underestimates of the quantity of timber available on the specified date, etc., which were not taken into account in estimating the number of units for purposes of depletion, or if it shall be found in the course of operation that timber included in the estimate is not merchantable as the result of deterioriation through rot or otherwise, or that the original estimate was too great, a new estimate of the recoverable units of timber (but not of the cost or the fair market value at a specified date) shall be made and when made shall thereafter constitute a basis for depletion. In the selection of the unit or units of estimate the custom applicable to the given type of timber in the given region should be considered.

Section 214 (a) 11.—DEDUCTIONS ALLOWED: CHARITABLE CONTRIBUTIONS.

Section 214 (a) 11, Article 251: Charitable contributions. 3–19–191. S–992.

Deductibility of Contributions to Council of National Defense.

Contributions to the Council of National Defense are deductible in ascertaining net income (Rev. Act of 1917, Sec. 1201; Rev. Act of 1918, Sec. 214(a), par. 11.)

The Council of National Defense was established by the Army Appropriation Act of August 29, 1916, "for the coordination of industries and resources for the national security and welfare." It consists of the Secretary of War, the Secretary of the Navy, the Secretary of the Interior, the Secretary of Agriculture, the Secretary of Commerce, and the Secretary of Labor. It is required to nominate to the President an advisory commission of seven persons, "each of whom shall have special knowledge of some industry, public utility, or the development of some natural resource, or be otherwise specially qualified, in the opinion of the council, for the performance of the duties hereinafter provided." It is made the duty of the council to supervise and direct investigations, and make recommendations to the President and the heads of executive departments, concerning a number of subjects of public importance connected with the national defense, such as the location of railroads with reference to the frontier, the mobilization of the military and naval forces, and the domestic production of articles essential to the Army, and necessary to the people during any interruption of foreign commerce. The Act contains numerous other provisions of the same character, and an appropriation is made to carry on the work.

The statute provides for the deduction, up to 15 per cent of the taxpayer's net income, of "Contributions or gifts made within the taxable year to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, * * * no part of the net earnings of which inures to the benefit of any private stockholder or individual," etc. (Rev. Act of 1918, sec. 214 (a), par. 11.) There was a similar provision in the Act of October 3, 1917. (Sec. 1201; adding par. Ninth to sec. 5(a) of the Act of September 8, 1916.)

The word "charitable" has a broad significance. Charitable gifts include, among other things, gifts for public and governmental purposes (11 Corpus Juris, p. 325), such as the repair of highways, the purchase of fire engines, and the establishment of life-boats or life-saving stations. (Id., pp. 325–326.) Thus, a gift to improve the condition of soldiers, and thus increase the efficiency of the Army, is charitable. (Id., p. 326.) It is also held that—"The test of a charitable gift or use and the test of a charitable corporation are in law the same." (Id., p. 303.)

The Council of National Defense was formed for important public ends. Gifts to it are charitable gifts; and it is, within the meaning of the statute, a charitable organization. It is not clear whether it is a corporation; nor is it material. This term in the statute includes "associations." (Rev. Act of 1918, sec. 1.)

It is held, therefore, that contributions to the Council of National Defense are deductible for purposes of the income tax, both under the Revenue Act of 1917 and the Revenue Act of 1918, up to the amount of 15 per cent of the net income of the taxpayer.

Section 214 (a) 11, Article 251: Charitable contributions. 8–19–321. S. 1052.

A gift of money to a board of education of a school district which has been created a body corporate under the laws of a State is an allowable deduction in computing net income within the limitation provided in section 214(a) (11), Revenue Act of 1918.

An opinion is requested as to whether a gift of money to a board of education of a school district which has been created a body corporate under the laws of the State of New York is an allowable deduction under the following provisions of section 214(a) (11) of the Revenue Act of 1918:

(*a*) That in computing net income there shall be allowed as deductions:

(11) Contributions or gifts made within the taxable year to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, * * * to an amount not in excess of 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph * * *.

(See also art. 251, Regulations 45, and sec. 231, Revenue Act of 1918.)

It appears from an examination of the laws of New York that boards of education in that State have been created bodies corporate under a special act of the legislature (secs. 300–328, Laws 1910, ch. 140); that such boards are organized and operated exclusively for educational purposes; and that no part of the income inures to a private stockholder or individual. It follows, therefore, from the foregoing language of section 214 of the Revenue Act of 1918 that a gift made to such an organization is exempt to the extent indicated therein. The mere fact that the gift may indirectly benefit the individuals of the State or district by reducing the possible tax burden does not change the rule. The case is distinguishable from a gift direct to the State or to some subdivision thereof which is not operated exclusively for educational purposes or which is not a body corporate.

Accordingly, it is held that a contribution or a gift of money to a board of education of a school district which has been created a body corporate by the laws of the State is an allowable deduction in computing net income within the limitation provided in section 214(a) (11) of the Revenue Act of 1918.

Section 214 (a) 11, Article 251: Charitable contributions. 23-19-546.
(Also Section 231, Article 517.) S. 1176.

INCOME TAX: SECTION 1201 (2), REVENUE ACT OF 1917, AND SECTION 214 (A) (11), REVENUE ACT OF 1918.

Contributions or gifts for the support of an association organized and operated exclusively for the purpose of giving musical concerts, the programs being of an educational character, and no part of the net earnings, under its charter, inuring to the benefit of any private stockholder or individual, are deductible, within the limits prescribed by the statute, in ascertaining the net income of the donor.

Solicitor's Memorandum 303 is overruled.

The question is presented whether under the act of September 8, 1916, as amended by the act of October 3, 1917, contributions made to the M Association are deductible in ascertaining the net income of the donor.

Section 1201 (2) of the act of October 3, 1917, amends section 5 of the act of September 8, 1916, providing for deductions in computing the net income of an individual, by adding at the end of subdivision (*a*) the following:

> Ninth. Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, * * * no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of 15 per cent of the taxpayer's taxable net income as computed without the benefit of this paragraph * * *.

In his income-tax return for the year 1917, A claimed a deduction of the amount donated by him during said year to the M Association. This deduction was disallowed and A was so notified.

The M Association is incorporate under an act which includes corporations formed for the promotion of "music, painting, or other fine arts," and is entitled "Corporations not for profit." The object of the corporation is to "encourage the performance of first-class orchestral music and it is actually engaged in giving concerts to which an admission is charged (but in all cases less than is charged for other entertainments of a like quality), and also free concerts. The programs rendered are made up of classical music and are of a character intended to educate the musical taste of the auditors. The association also affords to musicians who compose the orchestra musical training of a character not offered in schools or colleges of music. The annual expenses of the association have always exceeded its receipts and the deficit has been made up by the contributions of public-spirited men who receive no financial returns for their contributions. If they attend the paid concerts, they pay the same admission fee as others."

That no part of the income of the M Association inures to the benefit of any private stockholder or individual is not questioned. The only question is whether this association is "organized and operated exclusively for educational purposes" within the meaning of the act.

In In re Moses' Estate (123 N. Y., Supp. 443, 446) the court, in deciding that the Young Men's Christian Association of Brooklyn and Young Women's. Christian Association of Brooklyn were exempt from the transfer tax under the provisions of the statute that "any property devised or bequeathed * * * to any religious, educational, charitable * * * or infirmary corporation, * * * shall be exempted from and not subject to the provisions of this act," said:

"Educational" is not used in its meaning of instruction by school, college, or university, which is a narrower or more limited meaning of the word (Century Dictionary) but in its broader signification as the act of developing and cultivating the various physical, intellectual, and moral faculties toward the improvement of the body, mind, and the heart.

In Solicitor's Memorandum 578, in passing upon the question of the liability of the tax on admissions imposed by section 700 of the act of October 3, 1917, of an association formed to promote acquaintance with the Spanish language, in view of the provisions of said section exempting from tax "admissions all the proceeds of which inure exclusively to the benefit of religious, educational, or of charitable institutions or associations," it was said:

Nor is it necessary that the instruction be obtained in any particular way. It may be obtained in the form of lectures (Law Opinion 548), and the exemption is not confined to "educational institutions," such as schools and colleges. (Law Opinion 549.) Nor does it seem to be a valid objection that the "education" is obtained through intercouse between people who meet in a social way. Education, that is, need not necessarily be conveyed from a paid instructor to a pupil. (Solicitor's Memorandum No. 200.)

Music is recognized as one of the liberal arts and sciences and the importance of education in this subject is receiving constantly increasing recognition. Instruction in music is now part of the regular curriculum in every public school and it has come to be generally recognized that not only education in the actual production of music, but also education of the taste for music of the better class, form a part of a liberal education. That the instruction in music given by a musical association is conveyed in such a manner as to be pleasurable does not negative the fact that such instruction is educational.

It is held, therefore, that the M Association is an association organized exclusively for educational purposes within the meaning of section 1201 (2), Revenue Act of 1917, and section 214 (a) (11) Revenue Act of 1918, and contributions or gifts for its support, are deductible, within the limits prescribed by the statute, in ascertaining the net income of the donor.

Section 214 (a) 11, Article 251: Charitable contributions. 27-19-602. S. 1202.

DEDUCTIBILITY OF CONTRIBUTIONS TO A POLICE PENSION FUND.

Contributions made to a fund established for the pensioning of members of a municipal police force, where such fund is in control of a committee constituted by law, are contributions to charity within the meaning of section 214(a), paragraph 11, of the Revenue Act of 1918, and are deductible in computing the net income of the persons making such contributions.

Opinion is requested as to whether contributions to the police pension fund of Y City are deductible under the Revenue Act of 1918.

in ascertaining net income. Section 214(a), of the act of 1918, contains the following provision:

That in computing net income there shall be allowed as deductions: * * * (11) Contributions or gifts made within the taxable year to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, * * * to an amount not in excess of 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. * * *

The police pension fund of Y City, as it now exists, is established by an act of a State legislature. The act provides for the retirement and pensioning of members of the police force of Y City under certain conditions. The cases enumerated are (1) where a member of the force shall have become disabled or incapacitated while in the active performance of official duty; (2) where a member of the force shall have served 15 to 25 years and become permanently incapacitated; (3) in certain instances where there has been a period of service of at least 25 consecutive years. The act establishing the fund provides that it shall be in the custody of the treasurer of Y City, and that it shall be disbursed upon a written order of a board of trustees composed of certain designated city officials and five members of the police force. The question to be determined is whether a contribution to such a fund is a contribution made to a corporation organized and operated exclusively for a charitable purpose. The Revenue Act of 1918 provides (sec. 1) that the term corporation shall include associations. The board of trustees in the case under consideration is undoubtedly an association within the meaning of the act. It exists by direct authority of the State legislature and the law specifies who its members shall be. Therefore, if the purposes for which the pension fund was created may be considered to be charitable, contributions made to such fund are deductible.

While policemen are justified in relying on these pensions, they can not be said to be additional wages, because they are not paid by the employer, but by a fund which is distinct from the Y City. This distinction is borne out by the fact that the rules and by-laws of the act establishing the police pension fund provide that the board of trustees of that fund shall include five members of the police force of Y City, the said five members to be selected annually by vote of the members of the police force of Y City in active service. It is also to be noted that under the law the Y City would not be liable for the payment of pensions in the event the police pension fund did not contain sufficient funds to pay such persons. The act just referred to provides for the various sources from which the fund is to be built up; and, while contributions by the police force are not made compulsory, it is evident from the detailed wording of that section that members of the police force are expected to make voluntary monthly contributions to the trustees, in accordance with rank, the amount of such voluntary contributions being stated in a definite scale. The fact that the Y City is strongly represented on the board of trustees and the fact that it is required to appropriate annually not less than x dollars to the fund are not, in view of the foregoing considerations, sufficient to establish an identity between the city and the fund. Indeed, the sum of x dollars is so small in comparison with the needs of such an organization that the naming of this amount tends to indicate that the principal financial burden is not expected to be borne by the city.

In Solicitor's Memorandum No. 788 the question was under consideration as to whether the trustees of a teachers' retirement fund was an association organized for charitable purposes within the meaning of section 11 (a), sixth, of the Income Tax Law of September 8, 1916, exempting such an association from the tax. It was held that such a body was within the meaning of the act.

It is therefore held that contributions made to a fund for the pensioning of members of a municipal police force, where such fund is in control of a committee constituted by law, are properly deductible under section 214 (a), paragraph 11, of the Revenue Act of 1918.

Section 214 (a) 11, Article 251: Charitable contributions. 26–19–590. A. R. M. 2.

The Committee is of the opinion that the distinction of pew rents, assessments, church dues, and the like from basket collections is hardly warranted by the act. The act reads "contributions" and "gifts." It is felt that all of these come within the two terms.

In substance it is believed that these are simply methods of contributing, although in form they may vary. Is a basket collection given involuntarily to be distinguished from an envelope system, the latter being regarded as "dues"? From a technical angle, the pew rents may be differentiated, but in practice the so-called "personal accommodation" they may afford is conjectural. It is believed that the real intent is to contribute and not to hire a seat or a pew for personal accommodation. In fact, basket contributors sometimes receive the same accommodation informally. On these grounds, the Committee is of the opinion that ordinarily and customarily pew rents, as well as so-called assessments and so-called dues, are to be regarded as contributions.

It is accordingly recommended that this interpretation be adopted.

Section 214 (a) 11, Article 251: Charitable contributions. 1–19–56. O. D. 39.

Contributions by citizens of a city to a fund raised for the purpose of inducing an industrial plant to locate in their city are not deductible in calculating net income for income tax purposes.

Section 214 (a) 11, Article 251: Charitable contributions. 1–19–61. O. D. 44.

Contributions to the National Dry Federation are not deductible.

Section 214 (a) 11, Article 251: Charitable contributions. 2–19–152. O. D. 104.

Contributions made for the purpose of purchasing land and improving same for use as a public park or recreation ground, which is to be dedicated as a memorial to soldiers and sailors who served in the late war, are not deductible for income tax purposes.

Section 214 (a) 11, Article 251: Charitable contributions. 8–19–192. O. D. 126.

The value of property given by an individual to a public high school for athletic purposes is not deductible in the income tax return of such individual.

Section 214 (a) 11, Article 251: Charitable contributions. 8–19–322. O. D. 185.

Proportionate share of contributions made by partnership to charitable organizations may be claimed as deduction by individual member to amount not in excess of 15 per cent of taxpayer's net income computed without benefit of paragraph 11 of section 214 (a).

Section 214 (a) 11, Article 251: Charitable contributions. 11–19–379. O. D. 217.

Contributions to a family cemetery corporation organized under the laws of the State of New York are not allowable deductions.

Section 214 (a) 11, Article 251: Charitable contributions. 24–19–566. O. D. 299.

Premiums paid on a life insurance policy are allowable deductions from gross income when the beneficiary is a charitable corporation exempt from tax, provided the beneficiary named can not be changed at the option of the insured and the sum of the annual premium plus other allowable charitable contributions does not exceed 15 per cent of the taxpayer's net income.

Section 214 (a) 11, Article 251: Charitable contributions. 30–19–641. O. D. 345.

An association incorporated under the laws of Porto Rico for the purpose of soliciting and obtaining donations to be used in reconstruction work and for charitable purposes in portions of Porto Rico devastated by earthquake and tidal wave is held to be an association organized and operated exclusively for charitable purposes.

Contributions to such an association by individuals are deductible in income tax returns which are subject to jurisdiction of the Bureau of Internal Revenue to the extent provided in section 214 (a) 11, Revenue Act of 1918. Contributions by corporations to such an association are not deductible.

Income tax returns filed in Porto Rico are beyond the jurisdiction of the Bureau of Internal Revenue.

Section 214 (a) 11, Article 251: Charitable contributions.

(See 3–19–181; sec. 213 (b), art. 77.) Owner of nontax-free Liberty bonds, making a gift of the coupons attached, to an institution under section 214(a), 11.

Section 214 (a) 11, Article 251: Charitable contributions.

(See 20–19–511; sec. 219, art. 341.) Deductibility by an estate or trust of income set aside for a charitable corporation not yet in operation.

Section 214(a) 12.—DEDUCTIONS ALLOWED: LOSS IN INVENTORY.

Section 214 (a) 12, Article 261: Loss in inventory and from rebates. 3–19–193. T. B. R. 10.

In the case of a taxpayer making a return for a fiscal year beginning in 1917 and ending in 1918, sections 214(a) 12 and 234(a) 14 relating to loss in inventory apply to the computation of the tax under the Revenue Act of 1916 and the Revenue Act of 1917 at the 1917 rates as well as to the computation under the Act of 1918 at the 1918 rates.

Application of the provisions relating to inventory losses, to cases in which the return is made for a fiscal year beginning in 1917 and ending in 1918:

In section 205(a) of the Revenue Act of 1918 a method is provided for the computation of the income tax in the case of a fiscal year beginning in 1917 and ending in 1918:

SEC. 205(a). That if a taxpayer makes return for a fiscal year beginning in 1917 and ending in 1918, his tax under this title for the first taxable year shall be the sum of: (1) The same proportion of a tax for the entire period computed under Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917 and under Title I of the Revenue Act of 1917, which the portion of such period falling within the calendar year 1917 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1918 which the portion of such period falling within the calendar year 1918 is of the entire period: *Provided*, That in the case of a personal-service corporation the amount to be paid shall be only that specified in clause (1).

In section 335(a) of the same Act a substantially similar provision is made for the computation of the profits tax in the case of a corporation.

The Revenue Act of 1918 effected not only a substantial increase in the rates of both taxes, but also made a number of important changes in the rules for the computation of net income. Among the most important of these changes are the provisions of section 204(b) allowing an adjustment on account of net losses and those of sections 214 and 234 permitting increased deductions for interest paid (in the case of corporations) and for amortization, and the provision of the same sections relative to inventory losses.

It is important to note at this point that these four provisions are stated in three different forms, only two of them being in exactly the same form. The provision as to net losses is not included as a deduction in computing net income, but is found in a separate section. After definition of net losses in section 204(c) the section continues as follows:

(b) If for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount of such net loss shall under regulations prescribed by the Commissioner with the approval of the Secretary be deducted from the net income of the taxpayer for the preceding taxable year; and the taxes imposed by this title and by Title III for such preceding taxable year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provision of section 252. If such net loss is in excess of the net income for such preceding taxable year, the amount of such excess shall under regulations prescribed by the Commissioner with the approval of the Secretary be allowed as a deduction in computing the net income for the succeeding taxable year.

It has already been ruled in article 1623:

Net losses deductible from net income of the fiscal year under the provisions of section 204 of the statute shall be deducted in computing the tax attributable to the calendar year 1917, as well as in computing the tax attributable to the calendar year 1918.

On the other hand, the provisions of section 234 (a) 2 allowing practically a full deduction for interest paid by a corporation and of section 214 (a) 9 and 234 (a) 8 allowing a deduction for the amortization of war facilities are in the form of deductions in a section introduced by a provision "That in computing net income there shall be allowed as deductions." It would seem that this provision, taken in connection with the provisions of sections 205 (a) and 335 (a) referred to above, can lead to only one conclusion, namely, that the tax for the whole year at the 1917 rates is computed on the income as determined under the Act of 1916, as amended, and without the full deduction for interest in the case of corporations or any deduction for amortization, and that the tax for the whole year at the 1918 rates is computed on the income as determined under the Act of 1918 with a full deduction for interest and amortization. While such a ruling may not have been expressed at length in Regulations 45 it was contemplated as the only possible conclusion, as is evidenced by the following provision of article 185:

The taxpayers reporting on the fiscal year basis (a) in all computations based upon 1918 rates shall use the amount of such allowance apportioned to the calendar year 1918; (b) in any computation based upon 1919 rates for a year beginning in 1918 and ending in 1919 shall use the amount of such allowance apportioned to the calendar year 1919; and (c) in any computation for a fiscal year beginning in 1919 shall use as many twelfths of the allowance apportioned to the calendar year 1919 as there are months of such fiscal year falling in the calendar year 1919.

This special provision as to fiscal-year returns is based on and is consistent only with the conclusion just referred to.

The effect of the provision as to inventory losses is, however, not so clear. The provision of section 214 (a) 12 relating to individuals is as follows:

SEC. 214 (a). That in computing net income there shall be allowed as deductions: * * *

(12) (a). At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim is decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed then the remainder of the tax due shall on notice and demand by the collector be paid by the taxpayer with interest at the rate of 1 per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the Commissioner that such substantial loss has been sustained, then in computing the tax imposed by this title the amount of such loss shall be deducted from the net income. (b) If no such claim is filed, but it is shown to the satisfaction of the Commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described then the amount of such loss shall be deducted from the net income for

the taxable year 1918 and the tax imposed by this title for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

An identical provision is found in section 234 (a) 14. While this provision is found as one of the deductions in the Act of 1918 it is neither in form nor in substance a deduction. Furthermore, by its express terms it relates to a "Return for the taxable year 1918" and such a return includes a computation at the 1917 rates on the income computed under the Act of 1916 as amended as well as a computation at the 1918 rates on the income computed under the Act of 1918. It follows that its effect is substantially the same as that of the provision as to net losses under section 204 (b) rather than that of the provisions as to interest paid or amortization, which apply only to the computation under the Act of 1918.

It is recommended, therefore, that it be held that in a case of a corporation reporting for a fiscal year beginning in 1917 and ending in 1918, sections 214 (a) 12 and 234 (a) 14 relating to loss in inventory apply to the computation of the tax under the Revenue Act of 1916 and the Revenue Act of 1917 at the 1917 rates as well as to the computation under the Act of 1918 at the 1918 rates.

Section 214 (a) 12, Article 261: Losses in inventory and from rebates. 5–19–251. T. B. R. 15.
(Also Section 234, Article 561.)

Goods ordered in 1918 and delivered in 1919, where title has not passed until subsequent to the close of the taxable year 1918, can not be included in the 1918 inventory, and any loss realized upon such transactions are losses of the taxable year 1919.

The question has been raised as to what, if any, relief can be given under provisions of section 214 (a) (12) and section 234 (a) (14), in the case of taxpayers who in 1918 ordered goods which were not delivered to them until 1919, by which time a substantial fall in the market had occurred. In the cases to which attention is called the goods were merely ordered, and although the order appears to have formed a binding obligation upon the purchaser, the goods were not delivered nor had title passed to the purchaser on or before the close of the taxable year 1918. Under these circumstances it is clear that such goods can not be taken in the inventory of the purchaser. In so far as such goods were in existence at all they were taken in the inventory of the manufacturer or other predecessor owner of the goods or the materials composing them. The provisions of sections 214 and 234 above referred to relate specifically to losses upon inventories, and as the losses occurring in the cases now under consideration are not losses upon inventories, no relief can, therefore, be secured under these provisions.

Section 214 (a) 12, Article 261: Losses in inventory and from rebates. 8–19–323. O. D. 186.

Claims for losses in inventories of the taxable year 1918 are to embrace all items of the taxpayer's inventories so that gains made in any sales of certain items, or classes of goods, will be used to offset losses in others, and the net result as to the entire inventory determined. If the final computation shows a net gain over all inventory items sold, no claim for loss in any particular item or items will be sustained.

Section 214 (a) 12, Article 261: Loss in inventory and from rebates. 17–19–471. O. D. 263.
(Also Section 234, Article 561.)

Shrinkage in inventory values sustained during 1919 by a partnership business which prior to November 4, 1918, was operated as a corporation may not be taken as a deduction from the net income of the corporation for the taxable year 1918. The change from corporation to partnership precludes the individual taxpayer from charging any net losses against the former corporation taxpayer as such, even though the individual partners were stockholders of the former corporation.

Section 214 (a) 12, Article 262: Loss from rebates. 28–19–614. A. R. M. 4.

Recommended that rebates actually paid, other than under contract, should not be allowed under section 214(a)12 of the Revenue Act of 1918.

Advice is requested as to whether the claim of the M Company for abatement of x dollars of its 1918 income and profits tax should be allowed, the claim being based on certain rebates made to a customer in 1918, not paid under contract or any agreement entered into at the time goods were sold, but presumably allowed and paid voluntarily after the close of 1918 for the purpose of retaining the good will of the customer.

The Committee is of the opinion that there is no warrant of law for such allowance. The deduction allowed by section 214 (a) 12 of the Revenue Act of 1918 is in terms limited to "actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year." It might be argued that such payments are in reality a reduction of the sales price and that adjustment should be made accordingly, but if this theory were tenable then there would be no occasion for the inclusion in the law of the specific authority for the allowance of rebates paid under contract.

The Committee is therefore of the opinion that no other construction of the law is possible but that the payment must have been made in pursuance of a contract entered into during the taxable year.

Section 214 (a) 12, Article 263: Loss in inventory. 12–19–402.
(Also Article 267.) T. B. M. 52.

The memorandum submitted relative to the X Company, regarding inventory losses, involves two questions:

(*a*) Whether a taxpayer may submit proof to show that on certain portions of his inventory a loss has been sustained without showing whether profits have been made on other portions of the inventory, and

(*b*) What is the meaning of the term "temporary fluctuations"?

With regard to (*a*), Regulations 45, article 267, provides, inter alia, that "Not later than thirty days after the close of the taxable year 1919 a taxpayer who has filed either a claim in abatement or a claim for refund, or both, shall submit to the Commissioner a descriptive statement showing the quantity and kinds of all goods included in the 1918 inventory which have been (*a*) sold at a loss in the taxable year 1919, (*b*) sold at a profit during the taxable year 1919, or (*c*) not sold or otherwise disposed of during the taxable year 1919, * * *." The Regulations thus clearly require a statement showing the disposition of all of the inventory, and the regulations conform to the statute which speaks of the inventory. An inventory is a well-understood concept, and where the term is used without qualification it means the inventory as a whole, and not merely some part of the goods included in the inventory. The Advisory Tax Board is, therefore, of the opinion that an inventory loss can not be proved by a submission of evidence showing that a loss has been sustained in respect of a part of the inventory, without showing at least that the amount of the loss for which claim has been filed has not been offset by profits made on the remainder of the inventory.

The term "temporary fluctuation" as used in the statute is determined by its context. The statute is dealing with the taxable year 1918 and the taxable year 1919. Fluctuation in prices occurring within one of these years, and which does not develop into a steady settled market, must be considered temporary within the meaning of the act.

Section 214 (a) 12, Article 263: Loss in inventory. 1–19–64.
O. D. 47.

In fixing the cost of the manufactured articles inventoried, all of the costs of manufacture applicable to the particular article may be taken into consideration, but no claim will be allowed for speculative or anticipated profits. No claim should be made for the loss of an anticipated profit on labor, or material used in producing the articles.

Section 214 (a) 12, Article 266: Claims. 3–19–194.
T. B. R. 9.

Basis for claim in abatement for loss in inventory.

The Income Tax Unit has requested a ruling on the following question: "Is a taxpayer, in filing a claim for abatement due to shrinkage in inventory, to be allowed to compute his claim as at March 15, 1919, or June 15, 1919?"

The Advisory Tax Board recommends that a taxpayer filing a claim for abatement for loss in inventory should be required to base his claim in good faith upon all the information available to him at the time of filing his return for the taxable year 1918. The principal reasons upon which this recommendation rests are as follows:

(1) The letter of the statute permits a taxpayer to file a claim in abatement "at the time of filing return for the taxable year 1918." This language, it is believed, must be interpreted literally. When section 214(a) (12) was adopted it was well understood that extensions of the time for filing returns were practically inevitable. Had Congress intended to fix a particular day, it would have been easy to do so, or had it been intended to make the claim in abatement rest on conditions existing on March 15, 1919, it would have been easy and natural to employ some such language as the following:

"On the 15th day of the third month following the close of the fiscal year ending in 1916, or, if the return is made on the basis of the calendar year, then on the 15th day of March, 1919, a taxpayer may file a claim in abatement, etc."

(2) The fact that section 214(a) (12) does not fix with more precision the date as of which the inventory loss is to be determined, when the claim in abatement is used, is important. It signifies that the claim in abatement is essentially a tentative measure of relief designed to permit the taxpayer to utilize in advance an approximate estimate of the loss in inventory, to the end that the Government should not collect an excessive amount of tax or the taxpayer be deprived of the use of money belonging rightfully to him and not to the Government during the protracted period often required to consummate a claim for refund. The claim in abatement being essentially a preliminary estimate it is obviously desirable that it should cover as long a period as possible, in order that the actual sales data may be as complete as practicable, and that the longest possible period of time shall be given to ascertain whether the 1919 prices used in the inventory reappraisal of goods unsold shall not be affected by those temporary fluctuations which the statute is careful to exclude.

(3) It is accordingly recommended that the claim in abatement be computed or based on conditions existing as of the latest possible date authorized by law for filing returns for the taxable year 1918.

Section 214 (a) 12, Article 266: Claims. 6–19–275.
O. D. 164.

In case a taxpayer filed claim for abatement based on fact that he has sustained substantial loss from reduction in value of inventory, bond having been furnished, payment of second installment of tax should be based upon the tax computed on an amount of net income remaining after deducting therefrom amount represented by the claim. Abatement claims may be supplemented by supporting data relative to inventory pending consideration of claim.

Section 214 (a) 12, Article 268: Effect of claim in abatement. 21–19–525.
T. D. 2925.
(Also Section 1320.)

Bonds under sections 214 (a) (12), 234 (a) (14), and 1320 of the Revenue Act of 1918.

Sections 214 (a) (12) and 234 (a) (14) of the Revenue Act of 1918 provide in part as follows:

At the time of filing return for the taxable year 1918, a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim is decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest.

Section 1320 of the same act provides, in part:

That wherever by the laws of the United States or regulations made pursuant thereto any person is required to furnish any recognizance, stipulation, bond, guaranty, or undertaking, hereinafter called "penal bond," with surety or sureties, such person may, in lieu of such surety or sureties, deposit as security with the official having authority to approve such penal bond, United States Liberty bonds, or other bonds of the United States in a sum equal at their par value to the amount of such penal bond required to be furnished, together with an agreement authorizing such official to collect or sell such bonds so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bond. The acceptance of such United States bonds in lieu of surety or sureties required by law shall have the same force and effect as individual or corporate sureties, or certified checks, bank drafts, post-office money orders, or cash, for the penalty or amount of such penal bond. The bonds deposited hereunder and such other United States bonds as may be substituted therefor from time to time as such security may be deposited with the Treasurer, * * * of the United States, * * * which shall issue receipt therefor, describing such bonds so deposited. As soon as security for the performance of such penal bond is no longer necessary such bonds so deposited shall be returned to the depositor.

Article 268 of Regulations 45, provides in part as follows, relative to claims for losses in inventory and from rebates:

In the case of a claim in abatement filed with a return, payment of the amount of the tax covered thereby shall not be required until the claim is decided, provided the taxpayer files therewith a bond on Form 1124 in double the amount of the tax covered by the claim, conditioned for the payment of any part of such tax found to be due with interest at the rate of 12 per cent per annum. The bond shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds and shall be subject to the approval of the Commissioner.

The bond executed on Form 1124, pursuant to article 268 of Regulations 45, together with the abatement claim, should be forwarded by the collector to the Commissioner of Internal Revenue. When it is received by the commissioner it will be detached from the abatement claim and forwarded to the surety bond section of the Treasury Department for certification as to the sufficiency of the sureties. The surety bond section will, after certification, return the bond to the Commissioner for his approval. When he has approved the bond he will cause it to be attached to the abatement claim.

In case the claimant, in accordance with the provisions contained in section 1320 of the Revenue Act of 1918, elects to offer, in lieu of the surety or sureties provided for on Form 1124, United States Liberty bonds or other bonds of the United States as security, he should execute in duplicate a bond and agreement on Form 1124a, prescribed below. The original should accompany the United States bonds offered as security; the duplicate should be forwarded by the collector with the abatement claim to the Commissioner. If such bond and agreement is executed by a corporation, a duly certified copy of the resolution of the board of directors authorizing the execution should be attached. The United States Liberty bonds or other bonds of the United States offered as security shall at their par value be not less than the amount of the penal sum of the bond executed on Form 1124a, which shall be in double the amount of the tax covered by the abatement claim. The bonds so offered as security must be delivered to the Commissioner of Internal Revenue at the obligor's risk and expense. Coupon bonds can not safely be forwarded by registered mail unless insured by the obligor against risk of loss in transit. Registered bonds so offered as security must be registered in the name of the obligor and duly assigned to the Commissioner of Internal Revenue at or before the date of deposit with the Commissioner and need not be insured when forwarded by registered mail unless the obligor so elects. In connection with effecting insurance of bonds shipped reference is made to article 187 (a) of Regulations No. 2, revised.

The Commissioner of Internal Revenue will issue a receipt in duplicate for United States bonds so deposited with him as security, the original of the receipt to be given to the obligor and the duplicate to be retained by the Commissioner for his files. Upon receipt by the Commissioner of the United States bonds so offered as security and upon satisfying himself as to their ownership and as to the sufficiency of the agreement for him to collect or sell, and in case of registered bonds as to the regularity of the assignments, he will approve the bond executed on Form 1124a, and deposit the United States bonds offered as security with the Treasurer of the United States, as provided in paragraph 7 of Department Circular No. 154 (1919), dated June 30, 1919, and the Treasurer of the United States will, as provided in said circular, give receipt therefor in duplicate describing the bonds so deposited, the original to be delivered to the Commissioner of Internal Revenue and the duplicate to be retained by the Treasurer for his files.

Bonds of the United States shall be returned to the obligor as soon as the security for the performance of such penal bond is no longer necessary. Registered bonds shall be reassigned to the owner when the liability is canceled.

Section 214 (a) 12, Article 268: Effect of claim in abatement. 11–19–380. O. D. 218.
(Also Section 218, Article 321.)

Where a partnership desires to avail itself of the provisions of section 214(a) 12 and section 234(a) 14 of the Revenue Act of 1918, it is necessary for each member of the partnership to file a separate claim in abatement with respect to the tax assessed against his pro rata share of the profits of the firm. Each partner will also be required to furnish a separate bond in the requisite amount as required by article 268 of the Regulations.

Section 215.—ITEMS NOT DEDUCTIBLE.

Section 215, Article 291: Personal and family expenses. 20–19–507. O. D. 275.

Sums paid to a wife under terms of a marriage agreement are considered payments in discharge of a personal obligation of the husband and are not deductible in computing his net income subject to tax.

Section 215, Article 292: Traveling expenses.

(See 8–19–317; sec. 214(a) 1, art. 101.) Cost of transportation of salaried employee going to and from business.

Section 215, Article 294: Premiums on business insurance. 1–19–65. O. D. 48.

Where an insurance policy is taken out by a wife on the life of her husband and she pays the premiums thereon and becomes the beneficiary in the event of the husband's death, the amount of such premiums may not be deducted.

Section 215, Article 294: Premiums on business insurance. 13–19–422. O. D. 243.

Premiums paid by a partnership for accident and health insurance policies covering the lives of the individual partners are not deductible from gross income of the partnership.

Section 216.—CREDITS ALLOWED.

Section 216, Article 301: Credits against net income. 5–19–252.
(Also Section 234, Article 561.) T. B. M. 21.

Taxability of dividends received from foreign corporations deriving income from sources within the United States.

Any amount however large received as dividends from a corporation taxable upon income derived from sources within the United States, however small such income may be, is exempt from the normal tax under section 216 (a) or, in case the recipient is a corporation, under section 234(a) (6).

Section 216, Article 301: Credits against net income.

(See 28–19–612; sec. 213(b), art. 84.) Dividends from corporations having income exempt under section 213(b)7.

Section 216, Article 302: Personal exemption of head of family.

(See 3–19–184; sec. 213(b), art. 86.) The personal exemption allowed a married man and the exemption for dependents are not included in the $3,500 exemption for men in military service.

Section 216, Article 304: Credit for dependents. 4–19–220. O. D. 139.

An American citizen may claim the credit for dependents irrespective of the nationality or place of residence of the dependents.

Section 216, Article 306: Credits to nonresident alien individual. 1–19–66. O–785.

Rule for taxing income of person who becomes a citizen during the taxable year.

Where a nonresident alien taxpayer becomes a citizen or resident of the United States during the taxable year he is taxable for the entire year upon income derived from all sources.

Section 216, Article 307: When nonresident alien individual entitled to personal exemption. 20–19–508. T. D. 2922.

Amending article 307, final edition of Regulations 45, dealing with nonresident alien individual entitled to personal exemption and credit for dependents.

The final edition of Regulations 45 is amended by changing article 307 to read as follows:

ART. 307. *When nonresident alien individual entitled to personal exemption:* (a) The following is an incomplete list of countries which either impose no income tax or in imposing an income tax allow both a personal exemption and a credit for dependents which satisfy the similar credit requirement of the statute: Argentina, Belgium, Bohemia, Bolivia, Bosnia, Brazil, Bukowina, Canada, Carinthia, Carniola, China, Chile, Cuba, Dalmatia, Denmark, Ecuador, Egypt, France, Galicia, Goritz, Gradisca, Herzegovina, Istria, Lower Austria, Mexico, Montenegro, Moravia, Morocco, Newfoundland, Nicaragua, Norway, Panama, Paraguay, Persia, Peru, Portugal, Roumania, Russia (including Poles owing allegiance to Russia), Salzburg, Santo Domingo, Serbia, Siam, Silesia, Styria, Spain, Trieste, Tyrol, Upper Austria, Union of South Africa, Venezuela. (b) The following is an incomplete list of countries which in imposing an income tax allow a personal exemption which satisfy the similar credit requirement of the statute, but do not allow a credit for dependents: Bachka, Banat of Temesvar, Croatia, Salvador, India, Italy, Slavonia, Slovakia, Transylvania. (c) The following is an incomplete list of countries which in imposing an income tax do not allow to citizens of the United States not residing in such country either a personal exemption or a credit for dependents and, therefore, fail entirely to satisfy the similar credit requirement of the statute: Australia, Costa Rica, Great Britain and Ireland, Japan, The Netherlands, New Zealand, Sweden. The former names of certain of these territories are here used for convenience, in spite of an actual or possible change in name or sovereignty. A nonresident alien individual who is a citizen or subject of any country in the first list is entitled for the purpose of the normal tax to such credit for a personal exemption and for dependents as his family status may warrant. If he is a citizen or subject of any country in the second list he is entitled to a credit for personal exemption, but to none for dependents. If he is a citizen or subject of any country in the third list he is not entitled to credit for either a personal exemption or for dependents. If he is a citizen or subject of a country which is in none of the lists, then to secure credit for either a personal exemption or for dependents he must prove to the satisfaction of the Commissioner that his country does not impose an income tax or that in imposing an income tax it grants the similar credit required by the statute.

Section 216, Article 307: When nonresident alien individual entitled to personal exemption. 2–19–153. S–969.

Where a country imposes an income tax but does not levy a tax on income derived from sources therein by citizens of the United States, a citizen of such country who is a nonresident of the United States is entitled to claim the credits provided for in paragraphs (c) and (d) of section 216 of the Revenue Act of 1918 in preparing a return of income derived from sources within the United States.

The question has been asked as to whether a nonresident alien is entitled to the credits provided for in paragraphs (c) and (d) of section 216 of the Revenue Act of 1918, in filing a return of income derived from sources within the United States, if the country of which the nonresident alien is a citizen imposes an income tax, but such tax does not apply to citizens of the United States.

Section 216, paragraphs (c), (d), and (e), of the Revenue Act of 1918, provides:

(c) In the case of a single person, a personal exemption of $1,000, or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,000. A husband and wife living together shall receive but one personal exemption of $2,000 against their aggregate net income; and in case they make separate returns, the personal exemption of $2,000 may be taken by either or divided between them.

(d) $200 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer, if such dependent person is under 18 years of age or is incapable of self-support because mentally or physically defective.

(e) In the case of a nonresident alien individual who is a citizen or subject of a country which imposes an income tax, the credits allowed in subdivisions (c) and (d) shall be allowed only if such country allows a similar credit to citizens of the United States not residing in such country.

If a country does not impose an income tax, the credits provided in paragraphs (c) and (d), supra, may be claimed by a citizen of such country in filing a return of his income from sources within the United States. (Art. 307, Regulations 45.)

If a foreign country does levy an income tax, but such tax does not apply to income of nonresident aliens from sources therein, citizens of such country would be entitled to the credits allowed in these paragraphs in returning income from sources within the United States. The failure of a foreign country to tax nonresident aliens (which would include citizens of the United States) would have the same effect as to the nonresidents as though such foreign country did not impose an income tax.

It is therefore held that where a country imposes an income tax but does not levy a tax on income derived from sources therein by citizens of the United States, a citizen of such country who is a nonresident of the United States is entitled to claim the credits provided for in paragraphs (c) and (d) of section 216 of the Revenue Act of 1918 in preparing a return of income derived from sources within the United States.

Section 216, Article 307: When nonresident alien individual entitled to personal exemption. 2–19–154. O. D. 105.

An alien leaving the United States prior to end of a taxable year, if entitled to any personal exemption, may claim the full amount of such exemption for the entire taxable year.

Section 216, Article 307: When nonresident alien individual entitled to personal exemption. 15–19–446. O. D. 253.

In order that a nonresident alien may prove that his country satisfies the similar credit requirement of the income tax law, he should submit to the Commissioner a copy of the income tax laws of his native country, or an official communication from an accredited diplomatic representative of such country, showing that the country imposes no income tax, or in doing so grants similar credits required by statute.

Section 216, Article 307: When nonresident alien individual entitled to personal exemption. 20–19–510. O. D. 277.

Under royal decree promulgated by the Greek Government January 21, 1919, no discrimination is made against American citizens, resident or nonresident, consequently subjects of that country who are nonresident aliens as to the United States will be allowed the benefit of personal exemption and credits for dependents in computing their income tax liabilities to the United States.

Section 216, Article 307: When nonresident alien individual entitled to personal exemption. 24–19–567. O. D. 300.

Since the royal decree of the Greek Government allowing similar exemption to American citizens was not promulgated until January 21, 1919, the benefit of personal exemption and credits is, therefore, only extended to subjects of Greece, who are nonresident aliens as to the United States, for the taxable year 1919 and subsequent years.

Section 216, Article 307: When nonresident alien individual entitled to personal exemption. 24–19–568. O. D. 301.

Article 307 applies only to 1918 and subsequent years and has no application to the income tax of nonresident aliens for the year 1917.

Section 216, Article 307: When nonresident alien individual entitled to personal exemption. 27–19–603. O. D. 322.

Subjects of Luxemburg who are nonresident aliens as to the United States may claim the benefit of personal exemption and credit for dependents in computing income tax liability to the United States, since Luxemburg imposes an income tax but allows similar credits to nonresident aliens.

Section 216, Article 307: When nonresident alien individual entitled to personal exemption. 30–19–642. O. D. 346.

The right of a nonresident alien as to the United States to personal exemption and credit for dependents is contingent primarily on his citizenship. For example, a native-born Russian, especially one who has been living in the United States for a number of years, would still be regarded by this country as a citizen of Russia. This is rebuttable, however, by evidence of citizenship in Poland; and if an individual has in fact become a citizen of the new State, inasmuch as Poland is not included in the countries enumerated in Treasury Decision 2922, it will be necessary for him to comply with the requirements of the last sentence of that decision, in order to secure the benefit of the exemptions provided.

Section 216, Article 307: When nonresident alien individual entitled to personal exemption. 31–19–648. O. D. 350.

Switzerland imposed no income tax for the years 1918 and 1919. Citizens of Switzerland who are nonresident aliens as to the United States will be permitted to claim the personal exemption and credit for dependents provided in section 216, Revenue Act of 1918, in computing their income tax liability to the United States for those years.

Section 217.—NONRESIDENT ALIENS—ALLOWANCE OF DEDUCTIONS AND CREDITS.

Section 217, Article 312: Who is a nonresident alien individual. 3–19–175. O. D. 117.

A nonresident alien who has served in the United States Army for a period of one year is considered a resident of the United

States for income-tax purposes and is entitled to the same credits as to exemption as a citizen of the United States.

Section 217, Article 312: Who is a nonresident alien individual. 9–19–342. O. D. 197.

If an alien has been residing in the United States for as much as one year there is a presumption that such alien is a resident of the United States and this presumption will be indulged for purposes of income taxes in the absence of known facts showing that the alien is, in fact, a transient. A year's presence in the United States by an alien does not, however, establish residence beyond a doubt. It merely raises a presumption of residence which may be rebutted by any proper evidence showing that the alien is, in fact, a transient; that is, a nonresident.

Section 217, Article 312: Who is a nonresident alien individual. 9–19–343. O. D. 198.

The members of families of foreign ambassadors and ministers occupy the status of nonresident aliens for income-tax purposes.

Section 217, Article 312 (a): Alien seamen, when to be regarded as residents. 8–19–324. T. D. 2869(2).

Alien seamen—Amendment to article 312 of Regulations 45.

The final edition of Regulations 45 is amended by inserting immediately after article 312 a paragraph to be known as article 312a, as follows:

ART. 312a. *Alien seamen, when to be regarded as residents.*—In order to determine whether an alien seaman is a resident within the meaning of the income tax law it is necessary to decide whether the presumption of nonresidence is overcome by facts showing that he has established a residence in the territorial United States, which consists of the States, the District of Columbia, and the Territories of Hawaii and Alaska, and excludes other places. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel flying the United States flag and engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the territorial United States within the rules laid down in article 312, although the nature of his calling requires him to be absent from the place where his residence is established for a long period. An alien seaman may acquire such a residence at a sailor's boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1078, revised, or taking out first citizenship papers, is proof of residence in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient. The fact that a head tax has been paid on behalf of an alien seaman entering the United States is no evidence that he has acquired residence, because the head tax is payable unless the alien who is entering the country is merely in transit through the country. An alien may remain a nonresident although he is not in transit through the country. As to when the wages of alien seamen are subject to tax see article 92a.

Section 217, Article 312 (a): Alien seamen, when to be regarded as residents. 26–19–591. O. D. 315.

The term "foreign trade," as used in Treasury Decision 2869, includes the transportation upon the high seas of passengers and freight between the United States and foreign countries.

Section 217, Article 315: Duty of employer to determine status of alien employee. 1–19–68. O. D. 50.

If an officer qualified to administer oaths is not reasonably accessible, Form 1078 will be accepted if signed in the presence of an official of the employer company under whose supervision the employee's duties are performed and one other credible witness.

Section 217, Article 315: Duty of employer to determine status of alien employee. 3–19–195. O. D. 127.

The pay rolls of an employer may be accepted as written evidence of an employee's continuous residence in the United States, thereby establishing his status as a resident alien, unless the employer knows that the employee does not intend to remain here permanently. When an employer determines that his employee is a resident alien such employee is not required to file a personal return unless his net income amounts to or exceeds $1,000 or $2,000, as in the case of citizens of the United States.

Section 217, Article 315: Duty of employer to determine status of alien employee. 3–19–196. O. D. 128.

(Sec. 221, art. 372.) If a bona fide declaration on Form 1078 or its equivalent is filed by an alien with his employer on or before the last day of the taxable year of the alien, the employer may refund the entire amount of tax withheld during the year prior to the filing of such declaration and the employee will then be liable for the entire tax due upon his net income for such period.

Section 217, Article 315: Duty of employer to determine status of alien employee. 15–19–447. O. D. 254.

The fact that an alien has been employed by a resident corporation for at least three months is not ipso facto sufficient to permit the employer to refund the amount of any tax withheld. Forms 1115 and 1078 should be filed by resident or nonresident aliens in order to secure refund.

Section 217, Article 315: Duty of employer to determine status of alien employee. 24–19–569. O. D. 302.

Any income tax withheld during the calendar year from the wages paid to an alien employee, which has not been paid over to the Government, should be refunded to such alien employee upon the establishment of residence by the execution and filing of Form 1078 with his employer. As a condition precedent the employer should require the employee to return the receipts showing the amount of tax previously withheld before making the refund.

Section 217, Article 315: Duty of employer to determine status of alien employee.

(See 7–19–298; sec. 221, art. 361.) The duty of withholding as to nonresident aliens employed in a mine is that of the contractor rather than the operator or owner.

Section 218.—PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS.

Section 218, Article 321: Partnerships.

7–19–294.
T. D. 2858.

TAXABILITY OF INCOME FROM OR THROUGH PARTNERSHIP.

A member of a partnership need not include as a part of his net income subject to normal tax such of his income derived from or through a partnership as has been received by the partnership in the shape of dividends on stocks owned by it in corporations taxable upon their net income.

The law is so framed as to deal with the gains and profits of a partnership as if they were the gains and profits of the individual partners.

The appended decision of the District Court of the United States for the Northern District of Ohio, Eastern Division, in the case of United States of America, plaintiff, *v.* Harry Coulby, defendant (251 Fed., 982), which was on January 7, 1919, affirmed by the United States Circuit Court of Appeals, Sixth Circuit, is published for the information of internal revenue officers and others concerned.

IN THE DISTRICT COURT OF THE UNITED STATES, NORTHERN DISTRICT OF OHIO, EASTERN DIVISION. NO. 9771—LAW.

United States of America, Plaintiff, *v.* Harry Coulby, Defendant.
(Memorandum.)

WESTENHAVER, District Judge: This is an action at law to recover $588.45, with interest and penalties thereon, alleged to be due as unpaid income tax for the nine months ending December 31, 1913 under the Federal income tax law of 1913. A jury trial was waived by the parties and the case has been submitted to me for decision upon an agreed statement of facts. Briefly the facts are these:

The defendant, during the period in question, was a member of a partnership by the name of Pickands, Mather & Co. This partnership was then the owner of stocks in certain corporations which were taxable upon their net income under the provisions of section G of the income tax law. Dividends were declared and paid by these corporations upon the stocks held therein by the partnership. The defendant, in making return of his income for taxation, included as a part of his gross income his share of the profits of the partnership, but deducted therefrom such part thereof as was derived by or through the partnership from dividends on stocks in these corporations taxable upon their net income.

Later, on or about June 27, 1917, the Commissioner of Internal Revenue examined the defendant's return and disallowed the deductions thus made and assessed the normal tax of one per cent against the defendant on such deduction. The item of $588.45 represents that assessment.

The exact question presented for decision is whether or not a member of a partnership must include as a part of his net income subject to the normal tax, such part of his income derived from or through a partnership which has been received by that partnership as dividends on stocks owned by it in corporations taxable upon their net income under section G of the Federal income tax law of 1913.

Plaintiff's contention that profits thus derived are a part of the partner's net income, and subject to the normal tax, is based on the following paragraph of Section D:

"*Provided further*, That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section."

An examination of the entire income tax law convinces me that plaintiff's contention is erroneous. Section B defines what shall constitute the net income of a taxable person; it includes his gains, profits and income derived, not merely from salaries, wages or compensation for personal service, but also from businesses, trade, commerce, or sales or dealings in property, or the transaction of any lawful business carried on for gain or profit. This plainly includes such gains and profits derived from or through a partnership.

Section B also states what deductions shall be made from the gross income of a taxable person in order to ascertain the net income for the purpose of levying the normal tax. Among these deductions is the amount received as dividends upon the stock or from the net earnings of any corporation, joint-stock company, association, or insurance company which is taxable upon its net income.

Section G provides for the normal tax upon the entire net income of corporations. It expressly excludes partnerships therefrom. This net income of corporations is subject only to the normal tax, such as is levied on the income of any natural taxable person, and not to the additional tax provided for by subdivision 2 of Section A. This income from corporations received by a natural taxable person is exempt only from the normal income tax, and not from such additional tax.

Taking these provisions as a whole, the paragraph of Section D relating to partnerships above quoted, must be considered and construed in the light of the general scheme thus outlined. No provision is anywhere made requiring a return to be made by a partnership upon its income. This is true notwithstanding Section D requires copartnerships, having the control, receipt, disposal, or payment of fixed income of another person subject to tax, to make a return in behalf of that person and to deduct the same. This provision deals with the fiduciary relationship of guardians, trustees, executors, and so forth, having the possession and control of other person's property; but, as regards an ordinary partnership and it's ordinary business, the statement is true that no return is required to be made under the Federal income tax law of 1913 by a partnership.

Partnerships are expressly excluded from Section G, requiring returns and payment of the normal tax by corporations. If Congress had intended that partnerships, as such, should be taxable upon their net income, the logical place to have so provided would have been in Section G, and to have excluded from the net income of a natural taxable person, subject to the normal tax, that part of his income derived from a partnership just as is provided with respect to his income derived from a corporation.

This law, therefore, ignores for taxing purposes the existence of a partnership. The law is so framed as to deal with the gains and profits of a partnership as if they were the gains and profits of the individual partner. The paragraph above quoted so provides. The law looks through the fiction of a partnership and treats its profits and its earnings as those of the individual taxpayer. Unlike a corporation, a partnership has no legal existence aside from the members who compose it. The Congress, consequently, it would seem, ignored, for taxing purposes, a partnership's existence, and placed the individual partner's share in its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name.

It follows from these considerations that legally the defendant's share of the gains and profits of the Pickands, Mather & Co., derived from corporations taxable on their net incomes, is to be treated as if the same had been received by him directly from the taxpaying corporations.

The contrary contention is based on a literal reading of the words, "the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and tax paid." This sentence follows language plainly ignoring the existence of partnerships for taxing purposes. Section B had already provided what should be regarded as net income in language sufficiently comprehensive to include the gains and profits from business carried on in a partnership name. The words just quoted evidently apply only to the possibility that a partnership might not divide its gains and profits, but retain them in the firm name or business. It was to meet this possibility that these words were added, and not to provide an unequal and unique method of taxing a partner's gains and profits from a partnership.

The contention to the contrary is narrow and literal, even if not lacking in plausibility. It is a contention, however, contrary to the spirit and general policy of the act; it destroys uniformity and equality and should not be adopted unless required by the express language of the statute. In my opinion, the language of the statute does not so require; but, on the contrary, when the entire act is examined, it does give a right to the deduction.

Counsel for plaintiff invoke the legal principles, that an exemption in a tax law must be clearly expressed and will not be implied; that power to tax will not be taken away unless the law-making power has done so in clear and unequivocal language and that, inasmuch as uniformity and equality is difficult, if not impossible of attainment in tax laws, the inequality which might result from the Government's contention should not be permitted to control the language of the law. Numerous authorities illustrating these legal principles are cited. These principles are well settled, and, I assume ample power in Congress to have assessed defendant's income derived from a partnership in the manner contended for. It is my opinion, however, that Congress has not done so.

Counsel for plaintiff call attention to the fact that the Federal income tax law of September 8, 1916, now provides that members of partnerships shall be allowed credit for their proportionate share of partnership gains and profits derived from corporations taxable on their net income, and urge that this is a change of the law, and evidences a belief of the law-making body that the 1913 income tax law had provided differently. I do not agree with this contention. In my opinion, this provision was inserted in the 1916 act to put at rest the present controversy rather than to change the law, and is to be regarded only as a legislative recognition of the scope and intent of the prior law. The applicable authorities, in my opinion, are the following: Bailey *v.* Clark (21 Wall., 284); Johnson *v.* Southern Pacific Company (196 U. S., 1); Wetmore *v.* Markoe (196 U. S., 68).

Judgment is rendered in favor of defendant. An exception may be noted on behalf of plaintiff.

Section 218, Article 321: Partnerships. 25–19–585.
O. D. 311.

A foreign partnership is liable for tax under the 1917 act on the entire amount of profit derived from the sale of goods through its branch office or through its agencies in the United States. The basis of computation of profits should be the difference between the cost of the goods sold through its branch office or agent in the United States and the price received therefor and not merely the amount disclosed by the books of the branch office in the United States.

Section 218, Article 321: Partnerships.

(See 6–19–270; sec. 213(b) art. 72.) Partnership beneficiary of life insurance policy.

Section 218, Article 321: Partnerships.

(See 11–19–380; sec. 214(a) 12, art. 268.) Claim in abatement by partnership on account of loss in inventory.

Section 218, Article 322: Distributive shares of partners. 3–19–197.
O–816.

RETURNS OF PARTNERSHIP AND MEMBERS THEREOF FOR 1918; HOW RENDERED.

Where the fiscal year of a partnership has once been established neither the partnership nor its members will be permitted to make returns covering a period of more than 12 months.

Where a partnership distributes any part of its assets in kind, and a partner, in lieu of an undivided fractional interest in the whole, receives a full interest in a certain part of the assets distributed, such a change in interest does not constitute a closed transaction reflecting gain or loss.

A gain derived or a loss sustained by a partner by reason of the sale or other disposition of assets distributed in kind by the partnership before the end of its taxable year should be returned by the individual partner for the taxable year in which such gain was actually derived or the loss actually sustained, and the basis of computing such gain or loss is the difference between the cost of the assets to the partnership and the price or value realized when sold or otherwise disposed of by the partners.

The distributive share of the individual partners, whether distributed or not, of the net income of the partnership for its taxable year, and any gains or profits distributed by the partnership prior to the close of its taxable year, should be returned as income for that taxable year of the partners within which such taxable year of the partnership ends.

Section 218(a) of the Revenue Act of 1918 provides that:

There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if the net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

Section 200 provides that:

The term taxable year means the calendar year or the first year ending during such calendar year.

The partnership styled X company has heretofore kept its books on the basis of a fiscal year ending February 28. For the fiscal year of 1918, however, the partnership books were not closed until March 30 on account of the requirements of a State tax law. October, 1918, it distributed to its members various assets accumulated since 1850 and sold the bulk of its remaining assets to a corporation for nearly all of its stock. The partnership has not been dissolved and still retains certain assets which it is impossible to distribute at this time.

In this connection the following questions are asked with respect to the 1918 returns of the partnership and its members:

1. May the partners, in their individual returns for the calendar year 1918, show their shares of the undivided profits of the partnership from March 1, 1917, to March 30, 1918, ascertained as of March 30, 1918, when the partnership books were closed, or must such profits be ascertained as of February 28, 1918, and the profits for the month of March be included in the succeeding returns?

Neither the partnership or any member of it is permitted to make returns covering a period of more than 12 months. The returns rendered by the partnership for the fiscal year ending February 28, 1917, will be accepted as establishing a fiscal year for the firm ending as of that date, and the distributive share of each partner ascertained on February 28, 1918, whether distributed or not, should be returned as income for the taxable year of each partner, fiscal or calendar, as the case may be, within which the taxable year of the partnership, fiscal or calendar, as the case may be, ends. If, in this instance, the taxable year of each partner is the calendar year 1918, or the fiscal year which includes the date February 28, 1918, then in either event the distributive share of the partners ascertained as of

February 28, 1918, whether distributed or not, should be returned by the individual partners as income received during such calendar or fiscal year. The profits for the month of March, 1918, therefore, will be included in any returns made by the partners for the taxable year in which February 28, 1919, falls.

2. Should the individual returns show as gain or loss the difference between the cost to the firm (or value if acquired prior to March 1, 1913) of the assets divided among the partners between March 1 and September 30, 1918, and the value of such assets at the time of distribution?

Where a partnership distributes any part of its assets in kind, and a partner, in lieu of an undivided fractional interest in the whole, receives a full interest in a certain part of the assets distributed, such a change in interest does not constitute a closed transaction reflecting gain or loss. When, however, the property thus received by a partner is sold, any gain derived or loss sustained at the time of such sale will be measured by the difference between the selling price and the cost of the property to the partnership.

3. Should the returns show any income received by the individual members from the partnership between February 28 and December 31, 1918, involving gains accumulated by the partnership during that period?

Any income received by the individual members between February 28 and December 31, 1918, which was distributed by the partnership during that period, should be returned by them for the taxable year in which the taxable year of the partnership ending in 1919, ended, and not during the taxable year in which received by the partners if the partnership's taxable year did not end in that year. This rule finds support in the law itself. Section 218(a) provides that there shall be included in computing the net income of each partner his distributive share, whether distributed or not, etc., while section 218(e) recites that all provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof, provided that amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees. These two paragraphs together make it appear plain that Congress has recognized that there is a difference between the manner and time in which the profits or gains distributed by a partnership during the taxable year to partners are to be returned as income by the partners and the manner and time in which amounts distributed by a personal service corporation to its stockholders are to be returned as income by the distributees. Moreover, there is another good reason for the rule, namely, that until the end of the taxable year of the partnership has been reached it can not be determined whether the partnership books will show a gain or a loss to the individual partners for that year.

4. When should the undivided profits of the partnership earned between February 28 and December 31, 1918, but not yet distributed, be included in the returns of the individual members?

They should be returned as income for that taxable year of the individual members in which the taxable year of the partnership ends, whether such profits are distributed or remain undistributed at that time.

Section 218, Article 322: Distributive shares of partners. 22-19-536. T. B. R. 64.

PARTNERSHIPS.

Basis for reporting distributive share of net income of partnership by individual partners under various Income Tax Acts.

A Brothers, a partnership engaged in foreign trade, have a branch in Y City. Their business is such that it is not possible to close the partnership books for each year in time to permit the individual partners to report their distributive share of the net income of the partnership for that year for taxation at the time fixed by the statute. The partnership and the partners have in the past reported on the basis of the calendar year, and the individual partners have included in their returns for each calendar year their distributive share of the income accumulated by the partnership during the preceding calendar year. This practice was approved by the department, and the partnership wishes to continue it for the year 1918. This would mean that the income accumulated by the partnership in 1917 should now be reported by the partners as income for 1918. The excess profits tax under the 1917 law was assessed upon the 1917 income of the partnership.

Section 218 of the Revenue Act of 1918 reads in part as follows:

That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership *for the taxable year*, or if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

But one construction of this statute is possible, and that is adopted in article 322 of Regulations 45, which states:

The distributive share of the net income of a partnership which a partner is required to include in his return is his proportionate share of the net income of the partnership, either (a) for the taxable year upon the basis of which the partner's net income is computed, or (b) if the partner's net income is computed upon the basis of a taxable year different from that upon the basis of which the net income of the partnership is computed, for the taxable year of the partnership ending within the taxable year upon the basis of which the partner's net income is computed.

This satisfactorily and correctly disposes of the matter for 1918, contrary to the contention of the partnership. The past history of this particular rule, however, causes certain difficulties.

Subdivision (d) of section 2 of the act of October 3, 1913, provides:

That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of the partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid under the provisions of this section.

It will be noted that this language is substantially identical with the first part of section 218 of the Revenue Act of 1918 except that the words "for the taxable year" are added after the phrase "net income of the partnership" in the present statute. This phrase of the 1913 statute was repeated without change in the Revenue Act of 1916 and was not amended by the Revenue Act of 1917.

Treasury Decision 2090, approved December 14, 1914, under the act of October 3, 1913, stated that:

> The income from a partnership accrues to the individual partner at the time his distributive interest is determined and reducible to possession. In the returns of individuals made for the calendar year, therefore, there should be included such income accruing from the business of partnerships for their fiscal years as may have been definitely ascertained by means of a book balance, whether distributed or not.

This ruling was incorporated in article 4, Regulations 33 (revised), issued under the 1916 act, and adhered to after thorough examination in Law Opinion 689 under date of November 22, 1918.

It has been suggested that these rulings merely refer to the date as of which the books are closed and not to the time when the closing actually takes place and the distributive shares actually become known. Law Opinion 689 and the ruling in this particular case clearly indicate that the time when the accounts actually are closed is the time the "distributive interest is determined." This view is emphasized by the phrase "and reducible to possession" in Treasury Decision 2090.

It thus appears that there is an inconsistency between the ruling which must be made under the Revenue Act of 1918 and the view which prevailed upon this question under the earlier statutes. Obviously the department should not depart from a rule which has been in force since December 14, 1914, without clear and convincing reasons for such departure. An examination of the question under the earlier statutes in the light of our present knowledge, nevertheless, appears necessary.

The language used in such statutes is not clear. The considerations which may be urged for the view which has prevailed in the past in addition to its long existence are as follows: It is a practical rule, which accords with the understanding of business men. It is in accord with the principle of law that partners have no rights enforcible in law against one another as to partnership matters until there has been an accounting or settlement. Partnerships were permitted to establish fiscal years by an amendment in 1917 (retroactive as to 1916) although the individual partners were required to report on the basis of the calendar year. This made it obvious that, at least to that extent, the income of the partnership did not become *at once* income of the partner, and that the distributive share of the partner would be based upon an accounting period different from the one for which he is reporting as an individual.

Against this view may be urged the decision in Collector *v.* Hubbard (12 Wall., 118) holding under the act of June 13, 1864, that "gains and profits" of certain corporations "whether divided or otherwise" become *at once* taxable income of the stockholders, and that this decision was applicable to partnerships. The significance of the fiscal-year provision is counteracted by the adjustment made for changes in rates, indicating the intention to tax the income of the individual partners at the rates prevailing for the period during which such income was accumulated by the partnership, even though for practical reasons it was necessary to allow some leeway in the time for reporting the income for tax. Under the 1917 statute the partnership was subjected to excess profits tax as an entity on its income for 1917, and individual partners were permitted to credit for the purposes of the income tax a proportionate share of such excess profits tax imposed upon the partnership against their net income. The inference is strong that it was intended that the distributive share of the partner against which this credit might be taken should be a share of the partnership profits which were subjected to the excess profits tax.

But the strongest *contra* consideration is the case of United States v. Coulby (251 Fed., 982), affirmed by the Circuit Court of Appeals in January, 1919, since the approval of Law Opinion 639, and now published as Treasury Decision 2858. The case arose under the act of October 3, 1913, involving the liability of partners to report for normal tax their share of dividends received by the partnership from taxable corporations. The law contained no specific provision on the subject. If the dividends have been received directly by the partners as individuals instead of indirectly through the partnership, they would have been exempt from normal tax. The Government contended that this income lost its identity and character as corporate dividends when received by the partnership. The court overruled this contention and used the following significant language:

> This law, therefore, ignores for taxing purposes the existence of a partnership. The law is so framed as to deal with the gains and profits of a partnership as if they were the gains and profits of the individual partner. The paragraph above quoted so provides. The law looks through the fiction of a partnership and treats its profits and its earnings as those of the individual taxpayer. Unlike a corporation, a partnership has no legal existence aside from the members who compose it. The Congress, consequently, it would seem ignored. for taxing purposes, a partnership's existence, and placed the individual partner's share in its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name.

This decision, which is specifically applicable to the *character* of income received by the partner indirectly through the partnership is of equal force as indicating the *time when* such income should be accounted for by him. This result is consistent with that part of Law Opinion 689 which holds that income accruing to the partnership prior to March 1, 1913, is not taxable to the individual partners, even in case the amount of the distributive shares is determined after March 1, 1913.

In case the accounting periods of the partnership and the individual partners do not coincide, the latter shall include in his net income his distributive share of the partnership net profits determined at the close of any accounting period ending during his taxable year. Partnerships were first permitted to establish fiscal years by an amendment to section 8 (e) of the Revenue Act of 1916, made by section 1204 of the Revenue Act of 1917 (applicable to years ending in 1916). This same amendment provided for the adjustment necessary on account of any change in rates of taxation, and implicitly provided for the above method of accounting. This method of reporting is expressly required for 1918, and thereafter by section 218 of the Revenue Act of 1918.

It is, therefore, recommended (1) that, under the act of October 3, 1913, the Revenue Act of 1916, the Revenue Act of 1916 as amended by the Revenue Act of 1917, and the Revenue Act of 1918, it be the rule of the department that an individual partner must report for taxation as income of the year in which the partnership profits were accumulated his distributive share of such partnership net profits, whether distributed or otherwise, except (2) that in those cases in which the accounting period of the partnership and of the individual partner do not coincide the individual partner shall include in his net income his distributive share of the partnership net profits determined at the close of any accounting period ending during his taxable year. In those cases in which returns have been made contrary to the principles laid down in this recommendation it will be necessary to file amended returns.

Section 218, Article 322: Distributive shares of partners. 4-19-221. O. D. 140.

Income from a particular source can not be allocated to one partner of a partnership for income tax purposes, but must be divided pro rata among the several partners.

Section 218, Article 322: Distributive shares of partners. 8-19-325. O. D. 187.

In case two distinct partnerships enter into a single venture under agreement to terminate in two years no part of profit to be distributable or drawings allowed during that period and any profit to be held intact until the latter part of 1919, the amount of profit realized and determinable each taxable year should be reported proportionately in the respective returns of the partnerships regardless of the agreement. Individual members of each partnership are subject to tax upon their pro rata share of profit even though actual distribution is postponed until termination of the agreement.

Section 218, Article 322: Distributive shares of partners.

(See 3-19-182, sec. 213 (b), art. 86.) Member of partnership, turning over to partnership compensation received by him for services in the military forces of United States, may, in reporting his distributive share of the partnership's income, exclude an amount equal to the sum received for military services, turned over to the partnership.

Section 218, Article 322: Distributive shares of partners.

(See 10-19-354, sec. 202, art. 1570.) Distribution of profits in securities at less than cost to partnership.

Section 218, Article 322: Distributive shares of partners.

(See 20-19-505, sec. 213, art. 54.) Assignment of partnership profits to be earned in the future.

Section 218, Article 330: Distributive shares of stockholders in personal-service corporation. 4-19-222. O. D. 141.

A stockholder of a personal-service corporation having reported in his individual return for the taxable year his distributive share of the undistributed net income of the corporation for such taxable year, should not again report such income when it is actually received in a subsequent year.

Section 219.—ESTATES AND TRUSTS.

Section 219, Article 341: Estates and trusts. 1–19–70.
O. D. 51.

Amounts paid by an executor of an estate, out of his personal funds in discharge of obligations of the estate, such amounts being credited against the executor's liability for interest to the estate, are nevertheless income to the estate to the extent that they represent interest accrued since the death of the testator on obligations of the executor to the estate.

Section 219, Article 341: Estates and trusts. 3–19–198.
(Also Section 202, Article 1562.) O. D. 129.

If securities held in trust, the income from which is payable to an individual beneficiary, are sold at a profit, the amount received in excess of appraised value of securities at death of testator subsequent to March 1, 1913, or fair market value as of that date if decedent died prior to March 1, 1913, represents income to be accounted for by trustee on Form 1040.

Section 219, Article 341: Estates and trusts. 7–19–297.
(Also Section 223, Article 401.) O. D. 174.
(Also Section 225, Article 421.)

A "trustee in bankruptcy" is required to file a return of net income for the bankrupt's estate if the net income exceeds the specific exemption of $1,000.

The bankrupt individual is required to file a return accounting for his individual earnings but is entitled to the exemptions provided in section 216 of the Revenue Act of 1918.

Section 219, Article 341: Estates and trusts. 20–19–511.
(Also Section 214, Article 251.) O. D. 278.

When under the terms of a will or trust deed income is to be paid to or permanently set aside for a corporation or association of the kind described in section 231 (6) of the statute, such income is not deductible from gross income in the returns of the estate or trust where the corporation has received its charter but has not been completely organized or which has not begun to operate sufficiently to establish that it is exempt from the tax. Such income will be taxable to the estate or trust as an entity.

Section 219, Article 341: Estates and trusts. 26–19–592.
O. D. 316.

Where the same trustee is designated in a will to administer several trusts, the accumulated income of each separate trust will be taxable as an entity, not the income of the trusts combined.

Section 219, Article 341: Estates and trusts.

(See 10–19–351, sec. 1, art. 1504.) When trusts are not associations.

Section 219, Article 341: Estates and trusts.

(See 13–19–419, sec. 214 (a) 3, art. 134.) Deductibility of Federal estate tax in ascertaining the net income of estates.

Section 219, Article 341: Estates and trusts.

(See 14–19–433, sec. 213 (b) 7, art. 84.) Income from trust fund held by a city for charitable purposes, exempt from tax.

Section 219, Article 341: Estates and trusts.

(See 23–19–547, sec. 225, art. 425.) Ancillary executor to make return.

Section 219, Article 342: Estates and trusts taxed to fiduciary. 11–19–382. S. 1088.

Discretionary trusts; income received under taxable to recipient. Article 342, Regulations 45, discussed.

Where the income of a trust fund is payable only in the discretion of the trustees, such income as the trustees in their discretion distribute to the beneficiary during the years 1916 or 1917, is taxable to the recipient personally (Act of Sept. 8, 1916, sec. 2(b)). Such income, however, as is received in 1918 or later years by the trust estate is taxed to the trustees irrespective of the exercise of their discretion. (Sec. 219, Revenue Act of 1918; art. 342, Reg. 45.)

Opinion is requested as to the manner of computing the income tax of A for the year 1917. Section 2(b) of the Revenue Act of 1916 provides in part:

> Income * * * of estates or any kind of property held in trust, including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust shall be likewise taxed, the tax in each instance, except where the income is returned for the purpose of the tax by the beneficiary, to be assessed to the executor, administrator, or trustee, as the case may be. * * *

Section 8(c) of the same Act provides in part:

> Guardians, trustees, executors, * * * and all persons * * * acting in any fiduciary capacity, shall make and render a return of the income of the person, trust, or estate for whom or for which they act, and shall be subject to all the provisions of this title which apply to individuals * * *.

The testatrix B by her last will and testament created a trust under the terms of which the trustees were directed to hold certain property during the natural life of A and to apply the income thereof to his use, maintenance, and support.

It appears that the part devised in trust during the term of the natural life of A yields an annual income of 2x dollars and that this amount was paid over during the year 1917 by the trustees to A. A had during the year 1917 other income amounting to over 6x dollars, which he returned as an individual, and he now objects to the inclusion of the 2x dollars above mentioned in his individual return for 1917, on the ground that the income of the trust estate created by the will of B should be returned by the trustees and the estate taxed as an entity.

That portion of the will of B creating the trust for the benefit of A would seem to indicate an intention upon the part of the testatrix that A should have the entire income from the trust estate and that the trustees were to have no discretion concerning the payment of the same. But that portion of the will which follows indicates a contrary intention. Taking the will as a whole it seems clear that the testatrix intended to create, and in fact did create, a discretionary trust, the trustees having the right to determine the amount of the income that was "necessary or appropriate for the support of my said son and his family." Under the terms of this trust it thus appears that the income, or a part of it, might be accumulated from time to time. Under section 2(b), supra, it is provided that the income shall be taxed to the estate as an entity, where the income is accumulated for the benefit of "unascertained persons" or "persons with contingent interests." Income accumulated within the discretion granted in this trust would be of this character. The entire income so accumulated would consequently be treated as an entity for the purposes of taxation and would have to be returned by the trustees. (Law Opinion 599, Reg. 33 (revised), par. 207.)

In this case, however, the trustees did not see fit to accumulate the income of the trust estate or any part of it within the year 1917. The money paid is "income" in the hands of the recipient and should be returned by him in the year in which received. "The beneficiary will be required in the case of trust estates to account for the actual amounts distributed or credited to him." (Reg. 33 (revised), par. 210.) "The income of trust estates, as any other income, is subject to the income tax * * *. Any part of the annual income of trust estates not distributed becomes an entity and, as such, is liable for normal and additional tax * * *." (T. D. 2231; see also Law Opinion 599.)

From this it follows that, under the Revenue Act of 1916 as amended, where the income of a trust fund is payable only in the discretion of the trustees, such income as the trustees in their discretion distribute to the beneficiary is taxable to the recipient personally.

Article 342, Regulations 45, written as an interpretation of section 219 of the Revenue Act of 1918, states a contrary rule. That article contains the following sentence:

> Where under the terms of the will or deed the trustee may in his discretion distribute the income or accumulate it, the income is taxed to the trustee irrespective of the exercise of his discretion.

The provisions for the payment of the tax contained in section 219 of the Revenue Act of 1918 are, however, not the same as those found in sections 2 (b) and 8 (c) of the Revenue Act of 1916. Section 219 (c) provides that in the case of contingent interests "the tax shall be imposed upon the net income of the estate and shall be paid by the fiduciary." Under this section the tax is to be paid upon the income of a discretionary trust as an entity whether or not it is actually distributed. This is not true of section 2 (b) and 8 (c) of the Act of September 8, 1916. Section 2 (b) of that Act provides that "the tax in each instance, except when the income is returned for the purpose of the tax by the beneficiary, to be assessed to the executor, administrator, or trustee * * *." Under this section the fiduciary is not required to make a return of the income distributed by him to the beneficiary; rather the statute indicates that the beneficiary shall in all cases account for income distributed to him. Accordingly, under that Act the fiduciary has only been required to pay the tax upon such income as was accumulated or not distributed by him. Article 342, Regulations 45, can therefore have no application in the consideration of this case.

Section 219, Article 342: Estates and trusts taxed to fiduciary. 16–19–462. T. B. R. 47.

Revenue Act of 1918.—Income of an estate during the period of administration which is not paid or credited to a beneficiary is taxable to the estate even though such beneficiary was, as matter of law, entitled to be paid or credited with such income during that year.

Opinion is requested as to whether for purposes of taxation under the Revenue Act of 1918 certain income of the estate of A for the year 1918 should be included in the income of the estate or in that of the beneficiary, B. The facts are as follows: A died in 1916. In his will he named the X Company as executor and gave to it as trustee the residue of his estate in trust for B for life, with remainder over. It appears that during 1918 the estate was still in process of administration, but that the executor paid to B certain income and retained certain other income as a reserve for income taxes which might be assessed against the estate for the year 1918. It is contended (*a*) that the income retained by the executor was improperly retained, and (*b*) that since such income was improperly retained it should be treated as credited to the beneficiary during the year 1918, and should, consequently, be included in his income for that year.

The suggestion is made by the Income Tax Unit that, since the accounts of the executor for the year 1918 are not closed, it credit to B as of December 31, 1918, the amount of the income of the estate for that year which was retained as above stated, and that B report such income in an amended return for 1918.

Upon the facts submitted it is impossible to determine whether or not the income retained by the executor was properly retained. It is, however, unnecessary to determine this point, since the case can be disposed of by a decision of the other. For the purposes of this recommendation, therefore, it will be assumed, in accordance with the contention of the taxpayer, that the income in question was improperly retained.

The usual rule applicable to estates of deceased persons is that such an estate "during the period of administration or settlement" is taxable as an entity, the tax being paid by the executor. (See Revenue Act of 1918, sec. 219 (a) (1).) There is, however, an express exception to this rule, namely, that "there may be deducted the amount of any income properly paid or credited to any legatee, heir, or other beneficiary." (Sec. 219 (c).) The amount so deducted is to be included in the income of the beneficiary. (Sec. 219 (d).)

The income in question in the present case was neither paid nor credited to the beneficiary during the taxable year. The question is, therefore, whether since, as here assumed, it ought to have been so "paid or credited," it can be treated as if it actually was so "paid or credited," the making of an entry upon the executor's books being regarded as merely formal and, therefore, something which can be omitted or done later nunc pro tunc.

There is no warrant in the language of the statute for treating amounts which ought to have been paid or credited as if they were actually paid or credited. The statute provides with reference to trusts the income of which "is to be distributed to the beneficiaries periodically, whether or not at regular intervals" (section 219 (a) (4)) that the tax upon the income shall not be paid by the fiduciary (section 219 (d)); in other words, that the time of actual payment or crediting shall be disregarded. With reference to estates in process of administration or settlement, however, the statute, in the provision here under consideration, makes payment or crediting to the beneficiary the test as to whether the tax shall be paid by the fiduciary or by the beneficiary. It is to be presumed that the distinction was intentional else Congress would have made the same provision in both cases. Nor is the distinction without reason. The distribution of income is one of the principal functions of a trustee of a trust, the income of which "is to be distributed to the beneficiaries periodically, whether or not at regular intervals," and the determination of the amount of the distributive share of income of any beneficiary is relatively simple even though such amount has not been paid or credited to him. On the other hand, the distribution of income as such by an executor "during the period of administration or settlement" of an estate is an incidental function to be performed ordinarily only until a trust is set up and the determination of the amount of a distributive share of such income as of any period other than the time of payment or crediting is likely to be difficult.

The conclusion reached is not open to the objection that it makes tax liability dependent upon bookkeeping entries. The crediting of income to a beneficiary of an estate, which is referred to in the statute, is more than the making of a mere bookkeeping entry—the recording of an existing fact. It is in itself an act which separates the income of the beneficiary from the income of the estate, and from the standpoint of the beneficiary, effects a realization of income by him. In the opinion of the Advisory Tax Board there must be a transferring of income to the control of the beneficiary if there is to be a crediting of income within the meaning of the statute. For somewhat analogous situations see article 53 of Regulations 45. The crediting of income is not, therefore, a mere formality and can not be omitted or done nunc pro tunc. It is unnecessary, however, in the present case to determine precisely what constitutes a crediting of income to a beneficiary since there is here no act which can in any event be so regarded.

In view of the material difference in the language of the statute from that of earlier acts, rulings under those acts are of little assistance in the present inquiry.

It is held, therefore, that income retained by the executor of the estate of A in the year 1918 as a reserve for income taxes which might be assessed against the estate for that year should be included in the income of the estate and not in that of the beneficiary B.

Section 219, Article 343: Decedent's estate during administration. 1–19–71. O. D. 52.

There should be included in the return filed for a deceased stockholder of a personal service corporation the distributive share of the decedent in the profits of the corporation from the beginning of the year to the date the stockholder died. The return filed for the estate should include the distributive share in the profits of the corporation from the date of the stockholder's death to the end of the year.

Section 219, Article 343: Decedent's estate during administration. 11–19–383. O. D. 219.
(Also Section 214, Article 144.)

A loss can not be claimed in a return rendered for a decedent covering the taxable period to the date of his death where the cost of securities, or their fair market value as at March 1, 1913, if acquired prior thereto, is in excess of the value established by appraisal for the purposes of administering the estate, except in the case of a decedent who was a dealer in securities and regularly inventoried his securities and made his return accordingly. The executor should not make returns of book gains or losses, either up to the date of death or on transfer of the property to the legatee or to a trustee under the will, or from one trustee to a succeeding trustee, the appraised value remaining as the basis for computing all subsequent realizations of losses or gains in cash.

Section 219, Article 344: Incidence of tax on estate or trust.

(See 9–19–337, sec. 211(b), art. 13.) Trustees of assets of oil company, selling property, value of which has been demonstrated by exploration and discovery work by the trustees are liable to tax upon income from such property held in trust under section 211(b).

Section 219, Article 345: Estates and trusts taxed to beneficiaries. 1–19–69. S. 961.

MANNER OF TAXING INCOME DISTRIBUTED PERIODICALLY.

Where a trust provides for the distribution of income "when received" the beneficiary should account for it personally, whether distributed to him or not. (Revenue Act of 1918, sec. 219.)

Opinion is requested as to the taxable features of a trust created by A. The trustee is B. The declaration of trust executed by him recites that A has transferred to him y shares of the common stock of the M Company and all dividends upon the same, and that he holds the stock and dividends *in trust* to collect and receive the dividends accrued and to accrue upon said shares of stock and to pay the same when received to C until he shall have received payments amounting in value or in money to x dollars. After making said payments to C the shares of stock and any dividends and sums of money then remaining are to be assigned, transferred, and paid to A or to his executors or administrators.

The statute provides:

That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust including—

"* * * income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals." (Revenue Act of 1918, sec. 219a.)

Where the income is distributed periodically, it is provided that the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary his distributive share, whether distributed or not, of the net income of the estate or trust for the taxable year. (Sec. 219 d.)

Under the facts presented C is required to include in his personal return all income of the trust property for the taxable year, whether actually distributed to him or not.

No consideration is given to the method of accounting for the income in the year 1917, before the Act of 1918 took effect, since no question is asked on this point. What is sought is information as to whether the original owner of the property is liable to income tax during the trust period, and the inquiry is directed to the present law, the owner contemplating the creation of further trusts. He is not so liable.

It is held, therefore, that the beneficiary under the trust specified should account personally for the income, whether distributed to him or not, and that the creator of the trust is not liable for income tax with respect thereto.

Section 219, Article 345: Estates and trusts taxed to beneficiaries. 5–19–255. O. D. 156.

Where the income of an estate is to be distributed periodically by the trustees to the beneficiaries, and the trustees sell part of the principal or corpus of the estate at a loss, the beneficiaries are not allowed to deduct any part of the loss in their income-tax returns.

Section 220.—PROFITS OF CORPORATIONS TAXABLE TO STOCKHOLDERS.

Section 220, Article 351: Profits of corporation taxable to stockholders. 1–19–72. T. B. M. 2.

Section 220 does not apply to the case of a corporation which retains profits to meet the reasonable requirements of its business, such as for purposes of meeting maturing obligations, necessary increased working capital, additions to plant to be made in the immediate future, or other similar proper purposes, provided that such profits are withheld in absolute good faith, and not for the purpose of evading any tax or any rate of taxation in force at the time. Whether a corporation is taxable under section 220 can not be determined in advance; it must be determined at a later date in the light of what it has actually done with the profits retained.

Section 220, Article 351: Profits of corporation taxable to stockholders. 2–19–156. O. D. 106.

Corporations buying Victory notes with accumulated surplus will not subject their stockholders to the provisions of section 220, Revenue Act of 1918, unless the accumulated surplus is beyond the reasonable needs of the business. Investment of unreasonable surplus in Victory notes can not prevent the application of section 220, but obviously no unfavorable construction will be based upon the mere fact that a surplus is invested in Victory notes. Where a distillery or brewery business, between now and the time when national prohibition becomes effective, holds 1918 earnings or earnings of earlier years, either by reason of doubt as to the outcome of pending litigation or by reason of a desire to reinvest capital and accumulated earnings in a different business, such action of itself will not be regarded as bringing the corporation within the provisions of section 220.

Section 220, Article 351: Profits of corporation taxable to stockholders. 8-19-326. O. D. 188.

Section 220 of the Revenue Act of 1918 applies only to income of 1918 and subsequent years, and can not be utilized to force a distribution of unnecessary surplus accumulated in prior years. To such unnecessary accumulations, however, the provisions of the acts of October 3, 1913, September 8, 1916, and October 3, 1917, will be applicable according to the respective years in which such acts were in effect and such portions of the surplus were accumulated.

Section 220, Article 353: Unreasonable accumulation of profits. 15-19-448. S. 1117.

The question as to the unreasonable accumulation of undivided profits is one of fact to be decided upon a consideration of the volume of business done and the principles of sound business management. The fact that a corporation having capital stock of 10x dollars and doing an annual business in excess of 150x dollars has an accumulation of 55x dollars in undivided profits is not sufficient basis for finding that there has been an unreasonable accumulation of profits.

(S. 153 overruled.)

Section 221.—PAYMENT OF TAX AT SOURCE.

Section 221, Article 361: Withholding tax at source. 1-19-76. O. D. 56.

When a debtor corporation fails to withhold the 2 per cent tax where its bonds contain a tax-free clause and the owner has filed Form 1000, there is no obligation on the bank first receiving the coupons to withhold the tax, as assessment will be made against the debtor or its disbursing agent based on the tax liability as disclosed by the ownership certificates, Form 1000.

Section 221, Article 361: Withholding tax at source. 6-19-277. O. D. 167

Income tax should be withheld from interest payments to nonresident aliens upon bonds at rates in force during year in which payments were actually made, although bond interest is held to represent income for year during which coupons became due and payable. Any tax withheld and paid to Government in excess of taxpayer's liability may be adjusted through claim for refund.

Section 221, Article 361: Withholding tax at source. 7-19-298.
(Also Section 217, Article 315.) O. D. 175.

If the owner or operator of a mine leases a portion thereof to a contractor whose operations are separate and distinct from that of the owner or operator, and nonresident aliens are actually employed by the contractor, the duty of withholding as to such nonresident alien employees is that of the contractor rather than the owner or operator.

In the case of a claim for personal exemption by a nonresident alien employee for withholding purposes, the name and address of the employee should be secured by the employer, regardless of the fact that for the convenience of the employer the employee is known by number only.

Section 221, Article 361: Withholding tax at source. 10–19–359. O. D. 207.

A debtor corporation, having appointed a duly authorized withholding agent, should file with the collector for the district in which the debtor corporation is located, notice of such appointment, giving name and address of the withholding agent. Only one copy is required and no special form is prescribed.

Section 221, Article 361: Withholding tax at source. 11–19–385. O. D. 220.

A bank purchasing abroad coupons from bonds issued by domestic corporations will be held prima facie to be the recipient of income. Ownership certificates should, therefore, be secured from original owners of bonds in order that tax may be withheld as provided in sections 221 and 237, Revenue Act of 1918.

Section 221, Article 361: Withholding tax at source. 13–19–424.
(Also Section 213 (c), Article 92 (a).) O. D. 245.

Wages earned by a nonresident alien on an occasional coastwise voyage on a vessel generally making foreign voyages is income from sources within the United States and is subject to withholding.

Section 221, Article 361: Withholding tax at source. 18–19–485. O. D. 269.

When a bank in the United States collects interest upon foreign securities for its nonresident alien customers and credits same to their account, allowing interest on the balances maintained, the identity of the interest derived from foreign securities is lost, and the interest thus paid or credited is subject to taxation and withholding under the Revenue Act of 1918.

Section 221, Article 361: Withholding tax at source. 20–19–512. O. D. 279.

Scrip issued by a corporation to bondholders in payment of interest due upon its bonds is equivalent to cash payments and is subject to withholding under the rates in force at the time of issuance.

Section 221, Article 361: Withholding tax at source.

(See 1–19–16, sec. 213(c), art. 92.) Withholding obligations of a domestic corporation in case of payments to a nonresident alien individual or to a foreign corporation of interest on obligations of a foreign government.

Section 221, Article 361: Withholding tax at source.

(See 18-19-478, sec. 213(c), art. 92.) Withholding requirements in the case of interest on bonds of a corporation organized in the United States but doing no business nor owning property therein.

Section 221, Article 362: Fixed or determinable annual or periodical income. 2-19-157. S. 975.

Winnings of horses at a race track credited by the racing association to a nonresident alien owner and trainer of the horses winning such amounts are not fixed nor determinable annual or periodical gains, profits, and income within the meaning of section 221 (a), Revenue Act of 1918, and no withholding by the racing association is necessary.

Section 221, Article 363: Exemption from withholding. 2-19-158.
(Also Section 223, Article 404.) O. D. 107.

In cases where tax was withheld from wages of employees who refused to sign the old Form 1078, but who have now signed the new Form 1078, the amount of tax should not be refunded by the employer upon execution of the new Form 1078. The amount of tax withheld should be reported on Form 1042 and paid to the collector of internal revenue for the district in which the withholding agent is located, subject to claim for personal exemption provided in section 216 of the Revenue Act of 1918.

If the personal exemption is not available to the nonresident alien, the amount of tax can be refunded only upon execution of Form 46, accompanied by a complete return of the individual's income from sources within the United States, and evidence establishing the fact that tax has been withheld in excess of the actual liability.

Section 221, Article 363: Exemption from withholding. 4-19-224. O. D. 143.

In cases where Form 1078 is filed by aliens a record thereof should be made by the employer and certificates forwarded to the Commissioner of Internal Revenue, Sorting Division, Washington, D. C., not later than the 20th day of the month succeeding that during which the certificates were received.

Section 221, Article 363 (a): Personal exemption of nonresident aliens. 19-19-498. T. D. 2920.

Providing for relief of domestic corporations which have assumed payment of income tax with respect to tax-free covenant bonds owned by nonresident aliens who are entitled to credits for personal exemption and dependents, but whose incomes from sources in the United States do not exceed such credits.

The final edition of Regulations 45 is amended by inserting immediately after article 363 a paragraph which will be known as article 363a, as follows:

ART. 363a. *Personal exemption of nonresident aliens.*—In case a nonresident alien is entitled to personal exemption and credits for dependents in accordance with paragraphs (c), (d), and (e), section 216 of the Revenue Act of 1918, and his gross income from sources in the United States, including bond interest, does not exceed his personal exemption and credits for dependents, a certificate, Form 1001B, should be executed and filed with the withholding agent, if any part of the gross income is derived from interest upon bonds of a domestic corporation which contain a tax-free covenant clause. The certificate may be filed with the withholding agent at the end of the calendar year but not later than February 1 of the succeeding year and all such certificates should be attached to the annual list return, Form 1013. The amount of tax due from the withholding agent as shown by Form 1013 may be reduced by 2 per cent of the aggregate amount of interest payments made to the nonresident alien upon tax-free covenant bonds during the calendar year, and the amount of tax represented by the certificates, payment of which was assumed on monthly list return, Form 1012, will not be included in the assessment against the withholding agent. The certificate may be filed only by a citizen or subject of the countries enumerated in paragraph (a) or (b) of article 307, as amended. In case tax in excess of a nonresident alien's tax liability has been withheld from interest upon bonds which do not contain a tax-free covenant clause, the nonresident alien should file or cause to be filed with the collector of internal revenue a return of his gross income from all sources within the United States, accompanied by a claim for refund on Form 46.

Section 221, Article 364: Ownership certificates for interest coupons. 21-19-526. T. D. 2923.

1. In view of the fact that the revised forms of ownership certificates were placed at the disposal of the public over three months ago, this office is of the opinion that a reasonable period of time has elapsed in which to permit the public to have become familiar with them. In order, however, to prevent inconvenience to individuals and organizations required to use such forms, old forms of ownership certificates will be accepted with respect to interest due on and prior to November 1, 1919, when received from continental United States, and with respect to interest due on and prior to December 1, 1919, when received from abroad.

2. Banks and collecting agents, debtor corporations, and withholding agents shall refuse to accept the old forms, in connection with interest due, after the respective dates named herein, and collectors of internal revenue receiving monthly returns accompanied by certificates on the old forms, when it shall appear that such certificates were filed with debtor corporations or withholding agents, with respect to interest due subsequent to such dates, shall require the debtor corporation or withholding agent concerned to secure certificates on the revised forms.

3. In order that the fulfillment of the requirements herein provided may cause as little hardship as possible to individuals, banks, collecting agents, debtor corporations, etc., collectors should satisfy themselves that they have a sufficient supply of the revised forms on hand to meet anticipated demands, and where the supply is not deemed sufficient, requisition should be made without delay for such additional quantity as may be necessary. Collectors are requested to disseminate this information throughout their districts as quickly as possible.

Section 221, Article 364: Ownership certificates for interest coupons. 21-19-527. O. D. 284.

Bonds issued by the War Finance Corporation are not Government bonds, hence ownership certificates are required when coupons are presented for payment under article 364 of Regulations 45.

Section 221, Article 364: Ownership certificates for interest coupons.

(See 17–19–473, sec. 257, art. 1091.) Certified copies of ownership certificates.

Section 221, Article 365: Form of certificate where withholding required. 4–19–225. O. D. 144.

Form 1000, revised, should be used by nonresident alien individuals, fiduciaries, and corporations only when the bonds are issued by domestic or resident corporations, whether or not the bonds contain a tax-free covenant clause. A foreign corporation not engaged in trade or business within the United States which has a fiscal agent in the United States is not a resident corporation.

Section 221, Article 365: Form of certificate where withholding required. 29–19–628. O. D. 339.

Personal service corporations are to be treated, so far as practicable, on the same basis as partnerships for the purposes of withholding under section 221(b) of the Revenue Act of 1918. Corporations which have received notice from the Income Tax Unit that their returns as personal service corporations have been approved may thereafter and not before issue Form 1000 in collecting interest from bonds or other obligations of a corporation containing a so-called tax free covenant clause in the same manner and to the same extent that partnerships are authorized to use that form. The form should bear the stamped or written notation, "Approved by the Treasury Department as Personal Service Corporation on (date)."

Section 221, Article 366: Form of certificate where no withholding required.

(See 31–19–653, sec. 256, art. 1078.) Form of ownership certificate required from nonresident alien bondholders in the case of interest on bonds of a corporation organized in the United States, but transacting no business and owning no property therein.

Section 221, Article 370: Return of tax withheld. 16–19–463. O. D. 258.

Tax erroneously withheld from the wages of a nonresident alien seaman, who can not now be located for the purpose of making refund, should be reported on the annual list return, Form 1042, and paid to the Government, and when the seaman is located he should be advised of his right to file claim for refund.

Section 221, Article 371: Withholding in 1918. 2–19–159. O. 811.

Where a corporation withheld during the year 1918 tax pursuant to Revenue Acts of 1916 and 1917 from the income of foreign corporations not having an office or place of business in the United States, and such withholdings were made against dividends and bond interest paid to the foreign corporations, only such sums need be returned as are required to be withheld from income subject to withholding under the Revenue Act of 1918; any amounts withheld under the Revenue Acts of

1916 and 1917 from income not subject to withholding under the Revenue Act of 1918 may be paid over to the persons from whom they were withheld.

Section 221 (a), Revenue Act of 1918, which applies alike to nonresident aliens and foreign corporations (sec. 237), provides:

That all individuals, corporations, and partnerships in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States having the control, receipts, custody, disposal, or payment of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income of any nonresident alien individual (other than income received as dividends from a corporation which is taxable under this title upon its net income) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the commissioner under sec. 217) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 8 per cent thereof: *Provided*, That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities, the owners of which are not known to the withholding agent.

It appears that a corporation withheld during the year 1918 tax pursuant to the Revenue Acts of 1916 and 1917 from the income of foreign corporations not having an office or place of business in the United States and that the withholding was made against dividends and bond interest paid to such corporation.

The inquiry presented is as to whether or not the withholding agent should pay over to such foreign corporations the amount withheld in the case of dividends and only file return and pay over the amount withheld on bond interest, or whether the aggregate sum withheld against dividends and bond interest should be applied against the amount required to be withheld under the Revenue Act of 1918.

Under the Revenue Act of 1917 withholding at the rate of 2 per cent was required on the payment of dividends of domestic corporations to foreign corporations not engaged in business in the United States and not having an office or place of business therein. (Sec. 9.) Under the Revenue Act of 1918 dividends payable to a foreign corporation, where the dividends were received from a corporation which is taxable upon its net income, are exempted from withholding.

In Regulations 45, article 371, it is said:

In all such cases where a withholding agent withheld the tax pursuant to the Revenue Acts of 1916 and 1917 from the income of foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, he need return only the sum withheld to an amount not in excess of the aggregate sum required to be withheld by the terms of the Revenue Act of 1918 from income paid over by the withholding agent.

The term "aggregate" used in this article must be construed to include only such sums as are required to be withheld from income subject to withholding under the Revenue Act of 1918; that is, amounts withheld under the Revenue Acts of 1916 and 1917 from income which is exempted from withholding by the Revenue Act of 1918 may not be included in the "aggregate sum required to be withheld by the terms of the Revenue Act of 1918." Thus amounts withheld from a foreign corporation under the Revenue Acts of 1916 and 1917 from dividends of a corporation which was taxable upon its net income may not be included in the "aggregate" sum to be withheld under the Revenue Act of 1918, such income being expressly exempted from withholding under that Act. Sums so withheld may be paid over to the person from whom they were withheld.

It is, therefore, held that where a corporation withheld during the year 1918 tax pursuant to the Revenue Acts of 1916 and 1917 from the income of foreign corporations not having an office or place of business in the United States, and such withholdings were made against dividends and bond interest paid to the foreign corporations, only such sums need be returned as are required to be withheld from income subject to withholding under the Revenue Act of 1918; any amounts withheld under the Revenue Acts of 1916 and 1917 from income not subject to withholding under the Revenue Act of 1918 may be paid over to the persons from whom they were withheld.

Section 221, Article 372: Release of excess tax withheld.

(See 3–19–196, sec. 217, art. 315.) If Form 1078 or its equivalent is filed by an alien with his employer on or before the last day of taxable year, employer may refund entire amount of tax withheld during year.

Section 222, Article 381: Analysis of credit for taxes. 26–19–593.
(Also Section 214, Article 131.) O. D. 317.

Income and war-profits taxes paid to a foreign country by a citizen of the United States residing in such foreign country on income from sources within the United States can not be treated as a credit for taxes under section 222. Such taxes are deductible under section 214 (a) 3 in computing net income in his return to the United States.

Section 222, Article 383: Conditions of allowance of credits. 12–19–407.
O. D. 232.
(Also Section 238, Article 611.)

Where under a foreign income tax law corporations are required to withhold a fixed percentage of the total amount of dividends paid to the stockholders in this country, such tax being withheld in a lump sum, although imposed upon the individual stockholders, the amounts withheld not being itemized by the foreign government, in lieu of the individual tax receipts required to be attached to Form 1116, the taxpayer may attach to the return on Form 1116 his affidavit showing the number of shares held during the year, whether or not any of the shares held by him were acquired or sold during the year, giving dates and number of shares so acquired or sold; the total number of shares outstanding on which the dividend was declared regardless of whether the dividend was paid to citizens of the United States or other Governments; and the total dividends paid or accrued on such shares during the year, and attach to and make a part of such affidavit a certified copy of the tax receipts from the foreign tax collector showing the payment of the tax en bloc, with copies of any other documents which he may have that will serve to corroborate the facts set forth in such affidavit.

The amount of the credit claimed should be computed by dividing the total tax withheld by the total number of shares of the corporation outstanding and multiplying this result by the number of shares held during the entire year. In the event that any of the shares were acquired or disposed of during the year, an adjustment should be made showing the amount of taxes properly allocated to the dividends received after acquisition or before disposition of the stock.

Section 223.—INDIVIDUAL RETURNS.

Section 223, Article 401: Individual returns. 1–19–78. O. D. 57.

Where the property of an alien enemy has been taken over by the Alien Property Custodian in accordance with the provisions of the Trading With the Enemy Act, and the individual has executed a return but has no funds out of which to pay the amount of tax shown, the return should be filed with the collector of Internal Revenue for his district as required by law. The individual in such case can not be held responsible for failure to pay his income tax. The amount of tax is a debt due the United States Government which will be considered along with those of other creditors in the final disposition.

Section 223, Article 401: Individual returns. 21–19–528. O. D. 285.

A husband and wife can not divide the salary of the husband for the purpose of reporting such salary in separate returns for income-tax purposes. Income received by the husband, such as rents and interest from property owned by him prior to his marriage, must be reported by the husband after marriage, even though the wife is given a one-half interest therein by the community property law of the State.

Section 223, Article 401: Individual returns. 30–19–643.
(Also Section 252, Article 1036.) O. D. 347.

If a taxpayer has filed a tentative return for any taxable year or has paid any amount to a collector of internal revenue on the supposition that he will be liable for payment of tax, and later finds that his income was insufficient to require a return, a statement under oath to that effect should be filed in lieu of a complete return. If the taxpayer desires to file a claim for refund of the amount erroneously paid, a complete return will be required.

Section 223, Article 401: Individual returns.

(See 7–19–297, sec. 219, art. 341.) A trustee in bankruptcy is required to file a return of net income for the bankrupt's estate if the net income exceeds the specific exemption of $1,000.

Section 223, Article 404: Return of income of nonresident alien.

(See 2–19–158, sec. 221, art. 363.) Return to accompany claim for excess tax withheld.

Section 223, Article 406: Verification of returns. 29–19–629. T. D. 2951.

Article 406 of Regulations 45 is hereby amended to read as follows:

ART. 406. *Verification of returns.*—All income tax returns must be verified under oath or affirmation before an officer duly authorized to administer oaths either by the laws of the United States or by the laws of the State or Territory where such officer resides. Persons in the naval or military service of the United States may verify their returns before any official authorized to administer oaths for the purposes of these services. Income tax returns executed abroad may be attested free of charge before United States consular officers. Where a foreign notary or other official having no seal shall act as attesting officer, the authority of such attesting officer should be certified to by some judicial official or other proper officer having knowledge of the appointment and official character of the attesting officer.

Section 223, Article 406: Verification of returns. 8–19–327. O. D. 189.

American citizens in China, when executing their income-tax returns, may, when the services of a notary are not available, attach to their returns Consular Form 180, properly adapted and made a part of their tax return.

Section 224.—PARTNERSHIP RETURNS.

Section 224, Article 411: Partnership returns. 12–19–403. O. D. 228.

As the death or withdrawal of a partner ordinarily dissolves the partnership, a return would be required covering the period from the beginning of the partnership's taxable year to the date of its dissolution. If the business of the partnership is continued as such, a new accounting period would be established upon the necessary reorganization of the partnership, and its next return should cover the period from the date of reorganization until the end of the taxable year.

Section 225.—FIDUCIARY RETURNS.

Section 225, Article 421: Fiduciary returns. 1–19–79. O. D. 58.

A fiduciary should file Form 1040 for nonresident alien beneficiary, even though the individual's distributive share of income is derived from dividends and is less than $5,000.

Section 225, Article 421: Fiduciary returns. 10–19–360.
(Also Section 213, Article 31.) O. D. 208.

A fiduciary who is also the beneficiary of the trust should file a return for the estate or trust, and should also file an individual return showing his entire income derived from the estate and from all other sources.

Section 225, Article 421: Fiduciary returns.

(See 7–19–297, sec. 219, art. 341.) Trustee in bankruptcy is required to file a return of net income for the bankrupt's estate if net income exceeds the specific exemption of $1,000.

Section 225, Article 425: Return for nonresident alien beneficiary. 23–19–547. O. D. 292.
(Also Section 219, Article 341.)

The ancillary executor of the estate of a nonresident alien should make returns for the estate and pay the taxes due, as agent of the foreign executor, and file personal returns for 1918 for each nonresident alien beneficiary on Forms 1040 (revised) or 1040 (*a*) (revised); also a withholding return on Form 1042 (revised), accompanied by Certificate 1098 (revised).

Section 227.—TIME AND PLACE FOR FILING RETURN.

Section 227, Article 443: Extension of time by collector. 24–19–570. T. D. 2935.

Failure to file final returns where tentative returns have been filed. Article 443 of Regulations amended.

Section 1309 of the Revenue Act of 1918 (approved Feb. 24, 1919) provides in part as follows:

That the commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this act.

In pursuance of the foregoing provision of law, article 443 of Regulations 45 is hereby amended to read as follows:

ART. 443. *Extension of time by collector.*—It is important that the taxpayer render before the return due date a return as complete and final as it is possible for him to prepare. However, in cases of sickness or absence collectors are authorized to grant an extension of not exceeding 30 days, where in their judgment such further time is actually required for the making of an accurate return. See article 1002. The application for such extension must be made prior to the expiration of the period for which the extension is desired. The absence or sickness of one or more officers of a corporation at the time the return is required to be filed will not be accepted as a reasonable cause for failure to file the return within the prescribed time, unless it is satisfactorily shown that there were no other principal officers available and sufficiently informed as to the affairs of the corporation to make and verify the return. As a condition of granting an extension of time for filing a return the collector may require the submission of a tentative return and estimate of the tax on Form 1040–T in the case of individuals, or on Form 1031–T in the case of corporations, and the payment of one-fourth of the estimated amount of tax. Where a taxpayer has filed a tentative return and has failed to file a complete return within the period of the extension requested by him, the complete return when filed is subject to penalties prescribed for delinquency. Where a tentative return has been filed and no time has been fixed within which a complete return must be filed, the collector may at any time send notice to the taxpayer to file a complete return within a period of time therein specified by him, and a taxpayer who fails to comply with such request will incur the penalties prescribed by statute for delinquency in filing a return.

Section 227, Article 445: Extension of time in the case of persons abroad. 3–19–199. T. D. 2844.

Article 445, final edition of Regulations 45, amended to permit taxpayers residing or traveling abroad to pay at the time of filing returns only the installments of tax past due without interest at the rate of one-half of 1 per centum per month and other installments as they fall due.

The final edition of Regulations 45 is amended by changing article 445 to read as follows:

ART. 445. *Extension of time in the case of persons abroad.*—In view of the disturbed conditions abroad and the consequent interference with the usual channels of communication, an extension of time for filing returns of income for 1918 and subsequent years and for paying the tax is hereby granted in the case of nonresident alien individuals and nonresident foreign corporations, or their proper representatives in the United States, and of American citizens residing or traveling abroad, including persons in military or naval service on duty outside the United States, for such period as may be necessary, not exceeding 90 days after proclamation by the President of the end of the war with Germany. The installments of tax which are actually due must be paid at the time of filing the return and the other installments shall be paid as they fall due. In all such cases an affidavit must be attached to the return, stating the causes of the delay in filing it, in order that the commissioner may determine that the failure to file the return in time was due to a reasonable cause and not to willful neglect and that the return was filed without any unnecessary delay. If the showing justifies the conclusion that the failure to file the return in time was excusable, no penalty will be imposed. This extension is granted as a matter of general expediency to all persons abroad owing income, war profits, and excess profits taxes to the Federal Government and is not granted upon the request of any particular taxpayer. Accordingly, in the case of taxpayers who take advantage of this general extension of time for the filing of returns and the payment of tax no interest will be collected from such taxpayers, but where a request is made by a taxpayer and an extension is granted for other reasons by the commissioner interest will be collected at the rate of one-half of 1 per cent per month from the time the tax would have been due if no extension had been granted.

Section 227, Article 445: Extension of time in the case of persons abroad. 2–19–160. O. 809.

Where persons abroad or foreign corporations take advantage of the extension of time granted for the payment of tax, in article 445, Regulations 45, interest is not collectible at the rate of one-half of 1 per cent from such persons or foreign corporations from the time the tax would have been due if no extension had been granted.

A question has been asked as to whether interest is collectible at the rate of one-half of 1 per cent per month from soldiers and sailors on duty outside the United States where they take advantage of the extension of time for filing returns and payment of tax granted taxpayers residing abroad in article 445, Regulations 45.

Section 227 (a) of the Revenue Act of 1918 provides:

That returns shall be made on or before the 15th day of the third month following the close of the fiscal year or if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of March. The Commissioner may grant a reasonable extension of time for filing returns whenever, in his judgment, good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

Section 250 (a) of the Revenue Act of 1918 provides in part:

* * * Where an extension of time for filing a return is granted, the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the Commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed there shall be added, as part of such installment, interest thereon at the rate of one-half of 1 per cent per month from the time it would have been due if no extension had been granted until paid * * *.

For interest to be collectible, under section 250, *supra*, the postponement of the time of payment must be "at the request of the taxpayer." (Art. 1003, Reg. 45.) But under article 445, Regulations 45, the time for the payment of taxes is extended, under certain conditions, to all persons abroad owing taxes to the United States, in the following language:

In view of the disturbed conditions abroad and the consequent interference with the usual channels of communication, an extension of time for filing returns of income for 1918 and subsequent years and for paying the tax is hereby granted in the case of nonresident alien individuals and nonresident foreign corporations or their proper representatives in the United States, and of American citizens residing or traveling abroad, including persons in military or naval service on duty outside the United States for such period as may be necessary, not exceeding 90 days after proclamation by the President of the end of the war with Germany. The whole tax shown to be due must be paid at the time of filing the return. In all such cases an affidavit must be attached to the return stating the causes of the delay in filing it, in order that the Commissioner may determine whether the failure to file the return in time was due to a reasonable cause and not to willful neglect. If the showing justifies the conclusion that the failure to file the return in time was excusable, no penalty will be imposed.

This extension of time was granted by the Commissioner of Internal Revenue in order to take care of the unusual conditions caused by the war. It was granted alike to all persons abroad owing taxes to the Federal Government. The extension of time was granted as a matter of general expediency and not upon the request of any particular taxpayer. Accordingly, interest can not be collected from the time the tax would have been payable if the postponement had not been granted.

It is therefore held that where persons abroad or foreign corporations take advantage of the extension of time granted for the payment of tax, in article 445, Regulations 45, interest is not collectible at the rate of one-half of 1 per cent from such person or foreign corporations from the time the tax would have been due if no extension had been granted.

Part III.—Corporations:

Section 230.—TAX ON CORPORATIONS.

Section 230, Article 503: Corporations liable to tax. 4–19–227. S. 1001.

Where the holders of the entire common stock of a corporation agree to pool their stock interests and share in a certain portion of the profits accruing to the corporation according to fixed arbitrary percentage, rather than in proportion to their respective stock holdings, the corporation is still taxable as such and is not to be treated as a partnership for purposes of the income tax.

Section 230, Article 503: Corporations liable to tax.

(See 11–19–386, sec. 233, art. 541.) Gains derived from the sale of a corporation's assets with a view to its liquidation.

Section 230, Article 503: Corporations liable to tax.

(See 10–19–351, sec. 1, art. 1504.) When trusts are taxed as corporations.

Section 231.—CONDITIONAL AND OTHER EXEMPTIONS.

Section 231, Article 511: Proof of exemption. 1–19–85. O. D. 60.

A railroad company, which turns all of its income over to a charitable institution as a dividend does not come within the provision of section 231 (12), as it is actively engaged in the operation of a railroad system.

Section 231, Article 511: Proof of exemption. 7-19-300.
O. D. 177.

A corporation managed by five trustees, operating a theater building erected as a memorial, the net income from which is to be turned over to a city, for its use and benefit, is not one organized for the "exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof less expenses to an organization which itself is exempt from income tax," and is required to file returns of annual net income and to pay any tax thereby shown to be due.

Section 231, Article 511: Proof of exemption. 8-19-328.
O. D. 190.

In dealing with cases coming under section 231, the character of the corporation must be judged by its articles of incorporation, constitution, and by-laws rather than by the declarations of its officers or the method by which it conducts or has conducted its business. Accordingly, if the activities of a company are confined to cooperative selling for the benefit of its patrons, but it is granted additional powers by its charter, it will nevertheless be required to file returns and pay the tax if any shown to be due.

Section 231, Article 515: Building and loan associations. 19-19-499.
S. 1140.

INCOME TAX: ACTS OF OCTOBER 3, 1913, SEPTEMBER 8, 1916, AND FEBRUARY 24, 1919.

Building and loan associations.—Where a building and loan association has no other features which render it liable to income tax, it will ordinarily not be subject to tax merely because—

(1) It has paid-up shares which are (a) preferred as to earnings, and (b) have a definite rate of interest which may be higher than the rate of dividends paid on other stock (Park View Building & Loan Association *v.* Herold, 203 Fed., 876; C. C. A., 210 Fed., 577; T. D. 1941), or

(2) Its balance sheets show that it is lending considerable sums to nonmembers (Central Building, Loan & Savings Co. *v.* Bowland and Bellefontaine Building & Loan Co. *v.* McMaken, 216 Fed., 526), or

(3) It is a regular borrower of large sums of money which it uses for loans to members, the dues paid by members being entirely inadequate for the business transacted by it (Bellefontaine Building & Loan Co. *v.* McMaken, 216 Fed., 526, supra).

Where a building and loan association has an amount of paid-up capital which is so large as to be entirely out of proportion to the amount of running shares on which members are paying, it may or may not be liable to income tax, the liability to tax of such an institution depending upon the facts of the particular case.

Reference is made to the statement of the Income Tax Unit that from an examination of the reports of banks and building and loan associations it has become convinced that a large number of institutions are escaping taxation on the ground that they are building and loan associations when in fact they do not come within the words of the statutory exemption. Question is asked as to whether there is any obstacle to a holding that the following institutions are not exempt as not being within the words "domestic building and loan associations ——— organized and operated for mutual purposes and without profit":

(1) A building and loan association which has paid-up shares which are (a) preferred as to earnings, and (b) have a definite rate of interest which may be higher than the rate of dividends paid on other stock;

(2) Institutions whose balance sheets show that they are lending considerable sums as banks, dealing with nonmembers;

(3) Institutions which are regular borrowers in large sums of money which they use for loans to members; that is, which are operated on a plan under which the dues paid by members are entirely inadequate for the business transacted;

(4) Institutions in which the amount of paid-up capital is so large as to be entirely out of proportion to the amount of running shares on which members are paying.

The act of August 5, 1909, provided that nothing in section 38 of the act imposing an excise tax upon corporations should apply to domestic building and loan associations, organized and operated exclusively for the mutual benefit of their members. Paragraph "G" of section 2 of the act of October 3, 1913, provided that nothing in the section should apply "to domestic building and loan associations, nor to cemetery companies, organized and operated exclusively for the mutual benefit of their members." Section 11 (a) of the act of September 8, 1916, provided "That there shall not be taxed under this title any income received by any—

Fourth. Domestic building and loan association and cooperative banks without capital stock organized and operated for mutual purposes and without profits.

The provisions of the 1909 act and the 1913 act above quoted were very narrowly construed by this office. Thus article 87 of Regulations 33, dated January 5, 1914, provides:

Domestic building and loan associations are among those enumerated as exempt from the requirements of the law. A domestic building and loan association is held to be one organized under and pursuant to the laws of the United States, or of a State or Territory thereof, or under the laws applicable to Alaska or the District of Columbia. Mutuality in operation and in the distribution of profits and benefits is essential to exemption. Therefore, in order to come within the exempted class such associations must not only be "domestic," as defined, but they must be organized and operated exclusively for the mutual benefit of the members; that is, all the profits and benefits provided for in the articles of association and by-laws must be ratably distributed among all members, regardless of the kind of stock held, according to the amount of money they have on deposit. An association issuing different classes of stock upon which diffement rates of interest or dividends are guaranteed or paid, does not come within the exempted class.

Under this very narrow interpretation few building and loan associations were held to be exempt from tax. The Pacific Building & Loan Association of Spokane, Wash., claimed exemption and instituted suits against the collector for the recovery of taxes which it had been required to pay. The district court for the eastern district of Washington held that the company was not exempt from tax. It stated:

In view of the provisions for the loaning of the funds of the corporation to nonmembers, for issuing preferred or guaranteed interest-paying stock and that allowing the directors, upon finding that the income of the association can not be loaned profitably, to "cancel any outstanding certificates of general stock not borrowed upon," paying the holder the book value of the stock so canceled, thereby being authorized to retire any and all stock in their discretion (Pacific Building & Loan Association *v.* Hartson, 201 Fed., 1011).

The association was not exempt from tax.

Shortly thereafter suit was instituted against the collector for the fifth district of New Jersey for the recovery of taxes which the Parkview Building & Loan Association had been required to pay under the 1909 law. This association "issues two varieties of stock, one known as prepaid stock on which the full par value of $200 per share is paid by the holder thereof at the time of the issuance of said stock and upon which the plaintiff pays to the holder thereof out of the profits of the association the sum of 5 per cent per annum in lieu of participation by said stockholder in the general profits of said association." The question before the court was whether the issuance of this prepaid stock barred the company from exemption. The syllabus of the decision is to the effect that "where a building and loan association was organized under New Jersey Act, April 8, 1903 (P. L., page 457), and supplemental acts solely for the purpose of making building loans to its members who were entitled to vote in the management of the association's affairs according to membership and not by virtue of stock holdings it was an association within corporation tax law (act of Aug. 5, 1909), exempting such corporations from liability for the taxation, though under its plan of operation there might be inequality in the returns to the prepaying stockholders, etc., since the word 'mutual' is not to be considered as synonymous with 'equal.'" (Parkview Building & Loan Association *v.* Herold, 203 Fed., 876.) This decision was affirmed by the Circuit Court of Appeals (210 Fed., 577; T. D. 1941).

At approximately the same time suits were instituted by two building and loan associations in Ohio which borrowed from nonmembers and loaned to nonmembers. These were the cases of Central Building, Loan & Savings Co. *v.* Bowland, and Bellefontaine Building & Loan Co. *v.* McMaken (216 Fed., 526). In a lengthy and able opinion the court reviewed the functions of a building and loan association and reached the conclusion that both of these associations, organized in accordance with the statutes of Ohio, were exempt from tax within a fair meaning of the taxing statute. It called attention to the fact that "in the income-tax law of August 28, 1894, section 32 (Stat. L., p. 556), exemption is given to 'building and loan associations or companies which make loans only to their shareholders,' and in the war revenue law of June 30, 1898, section 17 (38 Stat. L., p. 455), is the provision that 'building and loan associations or companies that make loans only to their shareholders shall be exempt from the tax herein provided.'" Since there was no mention in the 1909 law that only those building and loan associations which made loans to their shareholders were exempt from taxation, the court inferred that it was the intention of Congress to exempt building and loan associations without regard to whether loans were made to other than shareholders.

With reference to the taxing acts of 1909, 1913, and 1916, it is to be observed that certain corporations are exempt from the taxes imposed by the several acts. Among these are mutual savings banks which have no capital stock and also domestic building and loan associations organized and operated for mutual purposes. Mutual savings banks are found principally in the New England States and in the State of New York. Building and loan associations are the principal savings institutions in the States of New Jersey, Pennsylvania, Ohio, and Louisiana. These institutions have ordinarily a well-defined method of operation. As stated by the Supreme Court of Pennsylvania in Folk *v.* State Capital, etc., Association (214 Pa., 543; 63 Atl., 1019):

The general purpose of building associations is the accumulation of funds to be loaned to their members and to be repaid in small periodical payments. The accumulation from the payment of installments on stock is so slow as often to hamper their practical operations, and different methods have been adopted to provide funds to meet the demands of borrowing members promptly and thus to promote the general purpose. Building associations are authorized by the act of June 25, 1895 (P. L. 303), to borrow money for temporary use when applications for loans exceed the accumulations in the treasury, and when a series of stock has matured. The issuing by these associations of full-paid stock to serve the same purpose as borrowing is an enlargement of their scope of operations not inconsistent with their original design, if properly restricted. While it has not been expressly authorized by the legislature, there is a distinct recognition of the practice by the act of June 22, 1897 (P. L. 178), which subjects such stock to taxation. We find nothing unlawful in the issuing of full-paid stock the dividends of which are not guaranteed but are limited in amount and payable only out of the profits, and the holders of which are entitled to no preference and have no advantage over other stockholders upon distribution in case of loss or insolvency, provided that the issue is incidental to the main business of the association and is intended to provide a fund from which loans may be made to the holders of installment stock. To this extent and for this purpose its issue is within the implied powers of such associations.

As a result of the narrow construction placed by this office upon the exemption accorded to building and loan associations by the 1909 and 1913 acts, Congress passed a private bill (No. 202, ch. 129, 39 Stat., 1491) and refunded to building and loan associations taxes which had been collected where the statute of limitations had run and the associations were barred from filing claims for refund. Practically all of the bona fide building and loan associations required to pay taxes under the earlier acts have had those taxes refunded to them. For the purpose of removing the test of mutuality as a condition for exemption from tax the taxing act of September 8, 1916, was so drafted as to provide that building and loan associations, organized and operated for mutual purposes and without profit, were exempt from tax. This office has hitherto assumed that this language was to be more broadly construed than the language of the earlier acts.

Apparently no case has come before the courts for a judicial determination as to when a building and loan association is organized or operated for mutual purposes. In the Parkview Building & Loan Association case (203 Fed., 876, 879) the court observed:

The word "mutual" can not always be considered a synonym of "equal." Mutual credits are not necessarily equal credits; mutual debts need not be equal in amount. That the issuance of prepaid shares does not destroy the mutuality among the members of a building and loan association is the opinion of Judge Endlich, whose work on building and loan associations is deemed an authority, as may be seen in his discussion of the subject in paragraphs 461 to 464. That view is also taken by the Supreme Court of Pennsylvania in Folk *v.* State Capitol Savings & Loan Association (214 Pa., 529, 63 Atl., 1013), where the supreme court affirms the lower court, which was presided over by Judge Endlich. The following quotation from Judge Endlich's opinion in that case is helpful. He says (214 Pa., 535, 63 Atl., 1016):

"That the allowance of a fixed dividend upon such paid-up stock out of the profits of the corporate business is a reasonable incident to its issuance, just to both classes of shareholders, and not calculated to give either an undue advantage over the other; that, on the contrary, the practical effect of the concurrent issuance of both installment and full-paid stock is likely to prove beneficial to both classes of shareholders; that no essential characteristic of the building association scheme can be regarded as forbidding and no essential purpose of it as defeated by this device; that it is contrary to no accepted rule of policy applicable to or involved in the nature of building associations."

It is believed that a building and loan association is organized and operated "without profit" within the meaning of the law when the total benefits or profits aside from a reasonable rate of interest or reasonable dividends paid upon prepaid shares accrue to the shareholders still making payments upon their shares.

Paid-up shares in a building and loan association are an anomaly. Liability to tax of such an institution must depend upon the facts arising in any particular case.

In conclusion, it is held that where a building and loan association has no other features which render it liable to income tax, it will ordinarily not be subject to tax merely because (1) it has paid-up shares which are (*a*) preferred as to earnings, and (*b*) have a definite rate of interest which may be higher than the rate of dividends paid on other stock (Parkview Building & Loan Association *v.* Herold (203 Fed., 876; C. C. A., 210 Fed., 577; T. D. 1941), or (2) its balance sheets show that it is lending considerable sums to nonmembers (Central Building, Loan & Savings Co. *v.* Bowland and Bellefontaine Building & Loan Co. *v.* McMaken, 216 Fed., 526), or (3) it is a regular borrower of large sums of money which it uses for loans to members, the dues paid by members being entirely inadequate for the business transacted by it (Bellefontaine Building & Loan Co. *v.* McMaken, *supra*). No attempt is made in this opinion to consider how far the tax liability of a building and loan association would be affected by the fact that it has an amount of paid-up capital which is so large as to be entirely out of proportion to the amount of running shares on which members are paying, nor to pass on any other features of operation which might be regarded as depriving the corporation of its status as a building and loan association.

Section 231, Article 516: Cemetery companies. 3–19–200. S. 991.

Held, upon consideration of the facts, that X Cemetery is exempt from income tax as a cemetery company operated exclusively for the benefit of its members. (Revenue Act of 1918, sec. 231, par. 5.)

The X Cemetery Co. is a corporation organized in order to purchase, improve, beautify, perpetuate, and manage X Cemetery. For this purpose it is given power to acquire, hold, convey, and encumber real estate, and to manufacture and sell vaults, mausoleums, and other cemetery appliances and improvements, and the right to own and operate greenhouses and conduct the business of florists. It seems clear that the greenhouse and florist business is but an incident of the cemetery; and the income therefrom, like all other income of the corporation, is disposed of in the manner described below.

The corporation has no capital stock, and pays no dividends to owners of lots. Every owner of a lot in the cemetery has the right to vote at meetings of the corporation. The object of the corporation is stated to be to retire an existing indebtedness; to raise certain money for improvement purposes; to pay the expenses of management; and to use the funds that may come to the corporation thereafter in beautifying said cemetery and in the perpetual care of lots and the grounds and property of the corporation. The income of the corporation is derived from the sale of lots, interest upon money received for the perpetual care of lots, and charges for burials. This income is applied to paying a caretaker, or the services of certain officers, and to pay interest upon indebtedness. None of it is credited to surplus or inures to the benefit of private stockholders or individuals.

The statute provides for exemption from income tax of "Cemetery companies owned and operated exclusively for the benefit of their members." (Revenue Act of 1918, sec. 231, par. 5.)

The corporation in question comes within the exemption. It is, in every respect, operated for the exclusive benefit of the lot owners, who constitute its membership. All of its income is applied in the common interest of such members. The fact that it pays interest on indebtedness is not material. It is not operated for the benefit of its creditors. (See Solicitor's Memo. No. 842.) Nor is it material that it controls a perpetual care fund, from which income is derived. This income, like all its other income, is expended for the common benefit of its members.

It is held, therefore, that X Cemetery Co. is exempt from income tax.

Section 231, Article 517: Religious, charitable, scientific, and educational corporations. 8–19–329. T. B. R. 33.

X Military School held to be subject to taxation under the Revenue Act of 1918.

The X Military School was incorporated under a law governing the formation of private corporations for manufacturing and business purposes. The corporation was organized and is operated for the purpose of conducting a military boarding school for boys. It has capital stock represented by shares. Its income is derived wholly from fees charged its patrons for board and tuition, uniforms, and other supplies furnished to cadets. As the corporation is now conducted, this income is used to defray the operating expenses and to pay an annual dividend to the stockholders, and the balance is invested as it accrues in grounds, buildings, and equipment needed in the business. The present stockholders of the corporation are all directors therein and give all their time and service to the business of the corporation.

The corporation in question is not exempt from taxation unless under section 231 of the Revenue Act of 1918, clause 6, which provides for the exemption of—

Corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

and is not exempt under that clause of the statute (1) unless it is "organized and operated exclusively for * * * educational purposes," and (2) unless "no part of the net earnings * * * inures to the benefit of any private stockholder or individual." It is claimed by the representatives of this corporation that it satisfies both of these requirements.

Whether a corporation which, however altruistic and laudable the motives of its incorporators and stockholders, was, in form, organized for profit, actually distributes a part of its net earnings to individual stockholders as dividends, and accumulates a surplus which may lawfully be so distributed if its directors so vote, and which upon dissolution must distribute its capital assets and accumulated surplus among its stockholders unless they consent to some other disposition thereof, could, by reason of the fact that its business is that of education, be said to be organized and operated exclusively for "* * * educational purposes," within the meaning of the statute, if these words stood alone, is a matter of grave doubt. (See Brunswick School (Inc.) *v.* Town and Borough of Greenwich, 88 Conn., 241; State *v.* Johnston, 214 Mo., 656. See also Regulations 45, art. 517, par. (2).) This question need not be decided, as the limitation of the exemption to corporations "no part of the net earnings of which inures to the benefit of any private stockholder or individual" disposes of the case.

It is conceded by the corporation that a part of its net earnings inures to the benefit of the individuals who are its stockholders, since dividends are paid to them. Probably, moreover, though it need not be decided here, the part of the net earnings which is allowed to accumulate inures to the benefit of stockholders within the meaning of the statute, since the value of the capital stock is thus materially enhanced. (See St. John's Military Academy *v.* Larson, 170 N. W., 269 Wis.) The taxpayer contends that it has no stockholder who is a "private stockholder or individual" within the meaning of the statute.

The consideration of this contention requires a close analysis of the statute. The word "private" modifies both the word "stockholder" and the word "individual." The expression "private stockholder" is somewhat unusual, but the expression "private individual" is not uncommon. (Note that the terms "stockholder" and "individual" somewhat overlap. Apparently the word "stockholder" was necessary to bring within the phrase corporate stockholders and the word "individual" was necessary to bring within it members of corporations who were not technically stockholders. All the stockholders in the present case are individuals.) The word "private" as applied to an individual ordinarily refers to such individual "in his private capacity" as distinguished from his capacity as one of the public or as a representative of the public. (Thus, in Bouvier's Law Dictionary, Rawle's 3d ed., "private" is defined as "affecting or belonging to individuals, as distinct from the public generally. Not clothed with office.") This is the natural meaning of the word "private" in the present statute as applied to an individual and must also be given to the word as applied to a stockholder. Earnings do not inure to the benefit of a stockholder or individual "in his private capacity" when they inure to him as one of the public or as a representative of the public. They do inure to a stockholder or individual "in his private capacity" when they inure to him as "separate" from the public and not as an "official" or representative of the public. This construction of the language gives to the word "private" a real significance, as it exempts from taxation corporations which are in the nature of public charities and those the stock of which is held in trust or otherwise for the public. It is in accord with article 517 of Regulations 45, which states with respect to clause 6 of section 231 of the Revenue Act of 1918, here under consideration, that—

> It does not prevent exemption that private individuals, for whose benefit a charity is organized, receive the income of the corporation or association. The statute refers to individuals having a personal and private interest in the activities of the corporation, such as stockholders.

A construction of the statute to the effect that no part of the net earnings of a corporation "inures to the benefit of any private stockholder or individual," if no part of such earnings inures to the benefit of a stockholder who is not an officer or employee of the corporation, on the ground that the officers and employees are "official" rather than "private" stockholders is, in the opinion of the Advisory Tax Board, unwarranted. An "official" stockholder as distinguished from a "private" stockholder is a representative of the public.

Upon the construction of the statute above set forth the corporation in question is clearly taxable. Each individual who is a stockholder therein receives his dividends "in his personal capacity" and not either as one of the public or as a representative of the public. He receives such dividends by reason of his private ownership of stock in the corporation, not by reason of his being a member of the public. Such dividends when received are his private property in the same sense as is his compensation received for services. Such dividends, which constitute a part of the net earnings of the corporation, inure, therefore, to the benefit of private stockholders or individuals. It is probable also that the accumulated earnings which enhance the value of the stock which is the private property of the stockholders are to be regarded as inuring to the benefit of private stockholders or individuals, within the meaning of the statute, though the determination of this point is not necessarily involved in the decision of this case.

It is held that the X Military School is subject to taxation under the Revenue Act of 1918.

Section 231, Article 517: Religious, charitable, scientific, and educational corporations. 23-19-548. O. D. 293.

An incorporated educational institution whose only source of income is from tuition and sale of uniforms and supplies to its students, and no part of the net income of which is distributed as dividends, but is expended in acquiring additional buildings and equipment, is not entitled to exemption. The corporation is considered as capitalizing its earnings by acquiring new buildings and equipment.

Section 231, Article 517: Religious, charitable, scientific, and educational corporations. 29–19–630. O. D. 340.

An organization incorporated for the purpose of establishing and maintaining a day nursery for young children whose parents are obliged to work and have no means to provide care for their children during the day, and deriving its income from subscriptions and donations, and a small amount from securities, all of which is used in promoting the activities of the nursery, is exempt from taxation under section 231 (6) of the Revenue Act of 1918.

Section 231, Article 517: Religious, charitable, scientific, and educational corporations.

(See 23–19–546, sec. 214 (a) 11, art. 251.) Musical association not organized for profit.

Section 231, Article 518: Business leagues. 1–19–86. O. D. 61.

An unincorporated association formed for the purpose of ascertaining the causes of losses sustained through navigation of vessels belonging to its members, thereby reducing such losses, any excess of fees, assessments, and interest received over current expenses and losses sustained by members being returned to members on a pro rata basis, is exempt from taxation and not required to file returns.

Section 231, Article 520: Social clubs. 1–19–81. S. 958.

COUNTRY CLUB EXEMPT FROM TAX.

A provision in the by-laws of a country club that in the event of the dissolution of the club the holder of a life membership shall participate in the distribution of the assets of the club after its other debts are paid, and before any sums are paid to either regular members or shareholders, is not alone sufficient to make the club liable to render income-tax returns.

Section 231 of the Act of February 24, 1919, provides:

That the following organizations shall be exempt from taxation under this title—

(a) Clubs, organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member.

The X corporation shows that it is a club organized for pleasure, social, and recreation purposes. Since its organization it has been continually operated and maintained exclusively for such purposes and is not and never has been operated for profit or commercial advantage. The club is supported exclusively by membership fees and dues. Its income and receipts are used for the payment of proper and necessary expenses of operation and maintenance. It maintains no surplus fund and none of its income or receipts inures to the benefit of any private stockholder, member, or individual. No stockholder, member, or individual receives any payment by way of dividend or otherwise from the income or receipts of the club except expenses incurred in the proper conduct of its business.

From the facts above stated it appears that this country club operates the same as any other country or social club might operate. The only ground for the disallowance of exemption appears to be that in the event of the dissolution of the club the holder of a life membership is to participate in the distribution of the assets of the club, after its other debts are paid and before any sums are paid to either regular members or shareholders.

A provision similar to this might be found in the by-laws of any social club. The foresight of the organizers or members of the club in incorporating this provision into the by-laws should not operate to bar the club from exemption. The facts are very clear that the club was not organized for profit, that no dividends are paid to the members, and that it was not organized with the expectation of dissolution. Such provison will not in itself bar the corporation from exemption from tax.

Section 231, Article 520: Social clubs. 2–19–162.
O. D. 108.

A club formed for the purpose of providing for the members thereof a suitable meeting place, a library, and a dining room, where meals will be furnished to the members, the income being derived from membership dues and the receipts for food, wine, and cigars purchased by members, and no part of the net earnings inuring to the private benefit of any member, is entitled to exemption from taxation and will not be required to file returns of annual net income.

Section 231, Article 520: Social clubs. 20–19–513.
O. D. 280.

A club organized for the purpose of promoting the principles and interests of a certain political party, deriving its income from membership dues and donations which are used for the purpose of defraying expenses necessary to the operation and upkeep of its rooms, no part of which inures to the benefit of any of its members, is exempt under section 231 of the Revenue Act of 1918.

Section 231, Article 521: Mutual insurance companies and like organizations. 1–19–83.
O. 790.

Where a casualty insurance association is organized for the purpose of insuring its members throughout the State, and not within a geographical subdivision thereof, and where it issues policies of insurance for stipulated cash premiums instead of depending upon assessments solely for the payment of its insurance liabilities, and where its annual surplus over all expenditures, losses, etc., may be returned to the members in the shape of annual dividends, and where the fund for the payment of salaries and other operating expenses is a large percentage of cash received by it, and it makes permanent investments of large amounts in Liberty bonds of the United States, the association can not be considered to be of the character of those exempted by section 231, subdivision (10), of the Act of February 24, 1919.

The X Casualty Co. is organized to insure employers against loss in consequence of accident or casualties of any kind to employees, or other persons, or to property, under certain conditions. Its character is that of a mutual cooperative association wherein there is no individual ownership or control of the assets or organization. The members in a body have regular meetings, in person or by proxy, direct the policy of management and the general operation of the organization. All corporations, firms, individuals, or estates having their principal place of business in the State may become members of this association.

In the constitution it is declared that the property, real and personal, of each member shall be liable only for its proportionate share of all investments. In the affidavit of the president and the secretary it is stated that the income of the association consists solely of contributions by its members for the payments of losses incurred and expenses of running the business. But in the by-laws of the association it appears that these contributions are derived from the issuance of policies of insurance for stipulated cash premiums based upon estimated wage expenditures and is called the premium fund, which is kept in two separate and distinct funds known as the claim fund and the general fund. A certain percentage of the premium fund is put into the claim fund, which is used only to pay losses, and the balance is put into the general fund to be used mainly for expenses, but may be resorted to if necessary to pay losses.

All surplus of contributions may be returned to the members as determined by them. The expenses of the association consist of salaries to officers, counsel, surgeons, clerks, inspectors, and other assistants, and office and other operating expenses necessary to the general conduct of the business.

Finally, under the order of the board of directors, a large sum has been placed in Liberty loan bonds of the United States. There is no statement that these bonds were afterwards sold.

Section 231, subdivision (10), of the Act of February 24, 1919, provides that the following organizations, among others, shall be exempt from taxation:

> Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, or fees collected from members for the sole purpose of meeting expenses; * * *

I. From all these facts and under the above section of the statute it must be concluded that the X Casualty Co. is not exempt from taxation. In the first place, the association is not an organization "of a purely local character." The words "of a purely local character" found in the above section would not include insurance companies operating over the whole of a State. "Purely local" refers to a very much smaller geographical area than a State. The word "local" has been considered in several tax cases; thus, In re Vanderbilt's Estate (10 N. Y. Supp., 239, 242) the Christian Home for Intemperate Men claimed exemption from State taxation under a special act which exempted from local taxation certain property. But the court held that such special act could never have been intended to extend to taxation by the State. So in People *v.* Pratt Institute (141 N. Y., 476; 36 N. E., 508) it was held that a State law providing that property in the city of Brooklyn used for the purpose of the Pratt Institute, the revenue of which shall be exclusively devoted to such purposes, "shall not be subject to local taxation" exempted such property from all taxation except for State purposes (Reversing 25 N. Y. Supp., 155.) Thus the word "local" refers to some political subdivision or section of the State. Consequently where a corporation's activities are limited only by the borders of its State it can not be considered to be purely local in character.

II. The income of the association consists not of assessments which are levied against the members from time to time as losses occur but are derived from stipulated cash premiums paid in advance. These premiums make up what is called a premium fund, and it is from this fund and not assessments from which losses are paid. Furthermore, all annual surplus of contributions may be returned to the members as may be determined by them at their annual meetings. These facts determine that the association is of a character different from that contemplated by subdivision (10) of the above section.

III. The large percentage of the premium fund which is devoted to the payment of the expenses of the association also shows that it is not of the character of the organization contemplated by subdivision (10) of the above section. It is more like the ordinary mutual insurance company which is run for gain as well as for the insurance that it offers to the members. The company employs a large force, consisting of officers, counsel, surgeons, clerks, inspectors, and other assistants, said to be necessary to the general conduct of the business, whereas in the ordinary organization contemplated by the above section and subdivision the expenses paid for salaries, etc., are limited to a very few persons and are merely nominal in amount.

IV. Regulations 45, part 2, under this act provide that the receipt of interest upon Liberty bonds, where they were purchased as a patriotic duty and were afterwards sold, will not defeat the exemption. But it does not appear from the facts given in this case that the company afterwards sold these bonds, so the inference must be that the bonds are still held for investment. Where such bonds are bought as a permanent investment, receipt of the interest destroys the exemption.

Therefore, it is concluded that where an association is organized for the purpose of insuring its members throughout the State and not within a geographical subdivision of the State, where it issues policies of insurance for stipulated cash premiums paid in advance instead of depending upon assessments solely for the payment of its losses, and where the fund for the payment of salaries and other operating expenses is a large percentage of the cash received, and where it makes permanent investments of large amounts in Liberty bonds of the United States the association is not of the character of those exempted by section 231, subdivision (10) of the Act of February 24, 1919.

Section 231, Article 521: Mutual insurance companies and like organizations. 1–19–82. O. 792.

A company or association which transacts business in more than one State may be "of a purely local character" within the meaning of section 11 (a), Act of September 8, 1916, as amended.

Opinion has been requested as to whether a company or association which transacts business in more than one State could be a "like organization of a 'purely local' character" within the meaning of section 11 (a) of the Act of September 8, 1916, as amended by the Act of October 3, 1917.

Section 11 (a) of the Act, as amended, reads as follows:

Tenth. Farmers' or other mutual hail, cyclone, or fire insurance company, mutual ditch or irrigation company, mutual or cooperative telephone company or like organization of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting its expenses.

An organization of a "purely local character" contemplates one whose business activities are confined to a particular community, place, or district. If its operations are extended beyond such a community, place, or district, it is not "purely local." The word "purely," as used in this section, intensifies and limits "local," and indicates the clear intention of Congress to exempt from taxation the income of only such "like organizations" as are entirely and unqualifiedly "local" in their operations; thus excluding all idea of organizations (other than those specifically named) whose activities are of a "general" as distinguished from a "local" character.

The business operations of such a "like organization" might be confined to a particular community, place, or district, thus bringing it within the meaning of the words "purely local character," and yet cover portions of more than one State. This question is not controlled by State lines. Not infrequently even small communities include within their boundaries portions of different States. The words "purely local character" imply a single locality, irrespective of political subdivisions. On the other hand, they clearly repel the idea of several different, disconnected fields of operation.

It is therefore held that a company or association which transacts business in more than one State may be a "like organization of a 'purely local' character" within the meaning of section 11 (a) of the Act of September 8, 1916, as amended by the Act of October 3, 1917.

Section 231, Article 521: Mutual insurance companies and like organizations. 1–19–87. O. D. 62.

Mutual health and accident associations are held not to be exempt under the Revenue Act of 1918.

Section 231, Article 521: Mutual insurance companies and like organizations. 1–19–88. O. D. 63.

A travelers' association providing for fixed death benefits to the beneficiaries of the members is held to be a mutual life insurance association rather than a fraternal beneficial society. Since the law provides no exemption for mutual associations of this character, they are liable for returns and must pay the tax, if any, shown to be due.

Section 231, Article 521: Mutual insurance companies and like organizations. 14–19–437. O. D. 252.

A mutual liability insurance company deriving its income from premiums and assessments of its members which are used to defray operating expenses and to indemnify its policy holders against amounts which they are required to pay under a workmen's compensation law, is not within the class of corporations specifically exempted by the Revenue Act of 1918 and must file a return showing its net income.

Section 231, Article 521: Mutual insurance companies and like organizations. 25–19–586. O. D. 312.

An insurance association incorporated under the laws of a certain State for the purpose of permitting automobile owners to exchange contracts of insurance and indemnity without becoming jointly liable as subscribers on any risks, its only source of income being from assessments, dues, and fees collected from members for the sole purpose of meeting expenses, is a "like organization of a purely local character" within the meaning of section 231 of the Revenue Act of 1918 and is exempt from income taxes.

Section 231, Article 521: Mutual insurance companies and like organizations. 26–19–594. O. D. 318.

A mutual irrigating ditch company providing for its expenses by assessment against its stockholders and receiving no other income except certain rents derived from the use of its surplus water does not comply with all the requirements of section 231 (10) inasmuch as its income does not consist solely of assessments, dues, and fees collected from members, and will be required to file returns of annual net income and pay any tax due thereon.

Section 231, Article 522: Cooperative associations. 1–19–84. S–952.

RIGHT TO EXEMPTION OF SALES AGENT ENGAGING IN BUSINESS.

Where an association, formed primarily in order to market the products of its members, also engages in the business of buying and selling at a profit, it is not exempt from income tax (Revenue Act of 1916, sec. 11(a), Eleventh; Revenue Act of 1918, sec. 231, par. 11.) Solicitor's Memo. No. 848 revoked.

Opinion is requested as to whether the X Fruit Co. is exempt from income tax. It is an unincorporated association of fruit growers. Its primary purpose is to assist its members to market their fruit, but it also buys and sells fruit on its own account and makes a profit in this way. It has also raised money to be used in the business of the company and in making loans to growers. It has been agreed to hold all profits so acquired intact until a certain date, at which time the profits are to be distributed among the members in proportion to fruit shipped through the association, or upon which, however sold, an assessment has been paid to the association.

The statute provides for the exemption from income tax of "Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them." (Rev. Act of 1918, sec. 231, par. 11.) There was a similar provision in the Revenue Act of 1916 (sec. 11(a), Eleventh).

The reference in the statute is to associations operating exclusivel as sales agents for their members. Where an association depar from this purpose and engages in an ordinary business pursuit—suc as the buying and selling of fruit—it is thereby removed from tl exempted class.

The company should consequently file returns of income, whic should include all earnings realized, whether distributed to membe: or not.

It is held, therefore, that the X Fruit Co. is not exempt from ii come tax.

Section 231, Article 522: Cooperative associations. 1-19-8! O. D. 6

An incorporated fruit growers' union which conducts its busine: at a profit, thereby accumulating a fund out of which dividends ai paid, is deprived of exemption from tax if it allows persons who ai not fruit growers to acquire stock and thus share in the profits. T the extent that it has such stockholders it loses its character as sale agent acting for the mutual benefit of the fruit growers, and accord ingly its exemption from tax also. The union may, however, deduc from gross income amounts periodically returned to members as refund of profits on business transacted with them, and proportione to the amount of such business.

Section 231, Article 522: Cooperative associations. 1-19-9(O. D. 65

A cooperative store managed by a university for the purpose o selling to its students supplies of every kind, and in case of dissolu tion its property reverting to the trustees of the school, does no come within the class of corporations organized for the exclusive pur pose of holding title to property collecting income therefrom an(turning over the entire amount thereof. It is actively engaged ii the operation of a business in which profits are realized and will therefore, be required to file returns of annual net income and to pa} any tax thereby shown to be due.

Section 231, Article 522: Cooperative associations. 8-19-330 O. D. 191

A cooperative creamery company which buys outright the product: of its members and distributes the proceeds on the basis of the num ber of shares held by each member instead of on the basis of th quantity of milk, or butter fat in the milk furnished by such mem bers, is not exempt from filing returns and paying any tax found t(be due.

Section 232.—NET INCOME DEFINED.

Section 232, Article 531: Net income.

(See 15-19-449, sec. 233, art. 541.) Net income for period coverec by return of telephone companies when operated under Governmen control.

Section 233.—GROSS INCOME DEFINED.

Section 233, Article 541: Gross income. 11–19–386.
(Also Section 230, Article 503.) S. 1090.

GAINS OF A CORPORATION IN PROCESS OF LIQUIDATION DERIVED FROM SALE OF PROPERTY.

Such gains of a corporation as are derived from the sale of its assets with a view to its liquidation and as are measured by the difference between the amount received from the sale and the fair market value of the property as of March 1, 1913, where it was acquired prior thereto, are taxable income of the corporation, whether or not it is in process of liquidation.

The question is presented by the X Company, whether its gains derived from the sale of its property in 1918, which were due to an increase in value of the property from and after March 1, 1913, are taxable income, in view of the fact that the company, immediately after the sale, proceeded to go into liquidation.

The X Company was chartered in 1909. It was organized primarily for the purpose of acquiring and developing a certain tract of land. This land was purchased immediately following the organization of the company, which engaged in no business, except such as was incidental to the care and development of the property. The land was never leased or otherwise used to produce income. There was considerable increase in value of the property from and after March 1, 1913. The company sold the property in January, 1918, receiving therefor an amount considerably in excess of its value on March 1, 1913, and immediately proceeded to go into liquidation. It wound up its affairs and distributed in liquidation the sum of 25y dollars. It was only prevented from making a final distribution by the circumstance that it was advised that the United States Government proposed to treat as income the profits arising from the sale of the land, and since the income rates for 1918 had not then been fixed by Congress it felt it necessary to reserve a sufficient sum to meet any contingency. After the passage of the Revenue Act of 1918 the company distributed the further sum of 3y dollars in liquidation, retaining merely enough to meet possible eventualities in the shape of taxation and legal liquidating expenses. The property sold comprised all of its assets. The company contends that under the special circumstances in its case no part of the sum realized from the sale of its assets should be treated as income.

By section 230 of the Revenue Act of 1918 there is levied a tax of 12 per cent upon the net income of every corporation for the calendar year 1918.

Section 232 provides that "net income" of a corporation means the gross income as defined in section 233, less the deductions allowed by section 234. Section 233 in turn defines "gross income" of corporations to mean "gross income" as defined in section 212, which is explained by section 213. These two sections make the term "gross income" include "gains, profits, and income derived * * * from * * * sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from * * * income derived from any source whatever." Section 213 specifically provides that "the amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer." Section 202 (a) provides "that for the purpose of ascertaining the gain derived * * * from the sale or other disposition of property, real, personal, or mixed, the basis shall be: (1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; * * *."

From these provisions of the Act clearly a corporation's gross income must include its gains received which were derived from the sale of its property and such gains are to be ascertained by taking the difference between the amount received for the property and its fair market value as of March 1, 1913, where it was acquired prior thereto. There is nothing in the Act to indicate that a corporation in process of or contemplating liquidation shall escape the tax imposed by the Act or in any way stand on a different footing from that of a corporation not in liquidation. Whether in process of liquidation is not made a determining element. Section 201 (c) provides that "amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits;" but this has reference to the stockholders of a liquidating corporation and points out how their distributive shares shall be treated in their hands for the purposes of their tax. It in no way directs or tends to direct that the tax imposed upon the corporation shall not be paid because it is in process of liquidation. Why should such a corporation escape the tax? It has received the gain; the gain is by the Act declared to be taxable income; the tax is imposed. There seems no escape from the conclusion that the corporation should pay the tax on such gain.

It is contended by the company that Lynch *v.* Turrish (247 U. S., 221) by implication places, for tax purposes, a liquidating corporation on a different footing from that of a corporation not in liquidation, but there appears nothing in the decision of the court to warrant such a conclusion.

The court decided that where the capital assets of a corporation increased in value prior to March 1, 1913, and thereafter a single and final dividend was paid in liquidation of the entire assets, without further appreciation or addition to the assets having accrued, no part of the dividend received by a stockholder is taxable under the Act of October 3, 1913. The stockholders' and not the corporation's gain was considered. The question of increase in value from and after March 1, 1913, was not before the court, but the language used is significant of what the court might hold in such a proposition. It said:

> If increase in value of the lands was income, it had its particular time and such time must have been within the time of the law to be subject to the law; that is, it must have been after March 1, 1913.

The terms of the Act therein considered (Act of Oct. 3, 1913) are different from the terms of the Act here under consideration (Revenue Act of 1918). The first did not specifically provide how and in what cases gains from the sale of property should be determined, whereas the latter Act does. The first levied a tax upon the net income arising or accruing in a taxable year, whereas the latter levies a tax upon the net income received in the taxable year. In this latter respect the Revenue Act of 1918 is more like the Act of August 5, 1909, which was construed by the Supreme Court to tax a corporation tax on portion of the gain which accrued subsequent to the incidence of the Act, as and when the gain was received through the sale of property. (Doyle *v.* Mitchell Bros. Co., 247 U. S., 179; Hays *v.* Gauley Mountain Coal Co., 247 U. S., 189; United States *v.* Cleveland, Cincinnati, Chicago & St. Louis R. R. Co., 247 U. S., 195.) No distinction was there drawn between a corporation in process of liquidation and one that was not. On such a proposition as the one here under consideration we look in vain for a court decision drawing such a distinction.

It is held that such gains of a corporation as are derived from the sale of its assets with a view to its liquidation and as are measured by the difference between the amount received from the sale and the fair market value of the property as of March 1, 1913, where it was acquired prior thereto, are taxable income of the corporation, whether or not it is in process of liquidation.

Section 233, Article 541: Gross income. 1-19-92.
O. D. 66.

The option exercised by a corporation beneficiary in allowing the proceeds of an insurance policy to be paid in installments represents in fact an investment of such proceeds. Any interest or profits received over and above the face value of each installment represents taxable income to the corporation for the year in which received.

Section 233 (a), Article 541: Gross income. 8-19-331.
(Also Section 213 (a), Article 31.) O. D. 192.
(Also Section 213 (b), Article 77.)

The excess of the amount of bonds purchased by a bank from the Government over the amount of such bonds subscribed for by the customers through the bank during the respective periods designated by the Government for receiving subscriptions is to be regarded as being the amount of principal of bonds originally subscribed for by the bank for its own investment. Such bonds are to be listed in the return of the bank as property of the bank subject to schedules 4 and A-4 of Form 1120, and the interest on such bonds is taxable income to the bank except to the extent provided in the Liberty loan acts and the supplements thereto.

The bonds subscribed for by the customers during the subscription periods on which no default has occurred are to be deemed the property of the customers and are not to be listed in the return of the bank, and the interest received from the Government on account of such bonds is not to be returned by the bank as income but is to be reported in the returns of the customers. The amount of interest received by the bank from its customers on account of bonds carried for them (including the amount represented by any coupons retained by the bank by way of adjustment of accrued interest) constitutes taxable income to the bank, and no part of such interest is exempt from tax, inasmuch as it is not interest on obligations of the United States but is interest on money advanced to the customers.

Section 233, Article 541: Gross income. 12–19–404. O. D. 229.

Telephone companies taken over by the Government, and whose compensation has been fixed by the Government, should include such compensation in the amount of gross income reported on their returns, in addition to the income, gains, and profits accruing from other sources during the taxable year. Companies whose compensation has not been fixed should include in the gross income, in addition to other income reported, the amount of operating income received, and when, later on, the President fixes the compensation for the use of their properties during the taxable year, they should file amended returns showing the total income received and recompute the tax on that basis.

Section 233, Article 541: Gross income. 12–19–405. O. D. 230.

A corporation owning a nine-tenths interest in a foreign partnership should, for the purpose of making income tax returns, treat the partnership and corporation as separate entities under the Revenue Act of 1918. The corporation would be taxable on its share of the partnership profits.

Section 233, Article 541: Gross income. 13–19–425.
(Also Section 326, Article 831.) O. D. 246.

No taxable income accrues to a public utility corporation from a mere book entry charging construction account and crediting income account due to charging interest on the company's own funds used temporarily for construction purposes, as permitted under the Interstate Commerce Commission's classification; neither will the company be allowed to include in its assets such amount of interest charged to capital account for the purpose of determining invested capital.

Section 233, Article 541: Gross income. 15–19–449.
(Also Section 232, Article 531.) O. D. 255.
(Also Section 326, Article 855.)

A telephone company should make a 1918 return for its accounting period, either calendar or fiscal year, and all income applicable to such period should be included in the corporation's return irrespective of the portion of the year during which it may have been operated under Government control. The invested capital should be computed on the basis of a 12 months' period and not prorated.

Section 233, Article 541: Gross income.

(See 21–19–520, sec. 201, art. 1541.) Dividends from foreign corporation under 1917 law.

Section 233, Article 541: Gross income.

(See 21–19–523, sec. 213, art. 52.) Income accruing to corporation from sale made by incorporators before company is incorporated.

Section 233, Article 542: Sale of capital stock.

(See 11–19–391, sec. 326, art. 831.) Commissions paid on sale of capital stock.

Section 233, Article 547: Gross income of corporation in liquidation. 12–19–406. O. D. 231
(Also Section 239, Article 622.)

A corporation entirely out of business maintaining its corporate existence merely for the purposes of liquidation and still holding income-producing investments not yet due is required to file income and excess profits tax returns for each year embracing the liquidating period. The income received by the corporation from its outstanding investments is to be returned for tax purposes.

Section 233, Article 549: Gross income of life insurance companies. 20–19–514. T. D. 2899.

Income Tax—Decision of court under Revenue Act of 1913:

1. *Dividends excluded from gross income.*—Under the provisions of paragraph G, subdivision (b) of section 2 of the act of October 3, 1913, that "life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder within such year," a life insurance company is not entitled to exclude from its total income during the taxable year, for the purpose of ascertaining its gross income, any dividends paid or credited to policyholders from whom it did not receive any premium during that year; and as to such policyholders as it did receive premiums from that year it is entitled to exclude only such part of the dividends paid to those policyholders as did not exceed the amount received from them, respectively, by way of premiums during that year.

2. *Dividends consisting of redundancies in previous premium payments.*—None of the cash dividends paid by a life insurance company to its policyholders which represent redundancies in previous premium payments are deductible from gross income in annual tax returns as "sums other than dividends paid within the year on policy * * * contracts."

Section 233, Article 550: Gross income of foreign corporations. 2–19–163. O. D. 109.

A citizen of the United States, resident abroad as agent of a domestic corporation, receives commissions from the domestic corporation and assigns them to a nonresident foreign corporation having no office or place of business in this country.

The foreign corporation will not be liable for income tax on the amounts received from the agent of the domestic corporation unless such amounts represent, in fact, payments of profits or income resulting from business conducted in this country on behalf of the foreign corporation.

The agent being a citizen of the United States must include the commissions in his return as income, notwithstanding that they were assigned to the foreign corporation.

Section 233, Article 550: Gross income of foreign corporations. 23–19–549. O. D. 294.
(Also Section 213, Article 91.)

The mere selling of raw materials in this country by a foreign corporation through the medium of a mail-order business or unsolicited orders, does not constitute transacting business within the United States and any income received from such transactions would not be subject to tax.

Section 234.—DEDUCTIONS ALLOWED.

Section 234, Article 561: Allowable deductions. 10–19–361. T. D. 2880.

RULING UNDER REVENUE ACT OF 1909.

Interest paid by a corporation on a sum representing premiums received from sale of its stock can not be deducted in ascertaining net income subject to tax under section 38 of the act of August 5, 1909.

Section 38 of the Act of August 5, 1909, imposes on corporations a special excise tax with respect to carrying on or doing business equivalent to 1 per cent upon the net income over and above $5,000, exclusive of certain stated amounts, and provides that such income shall be ascertained by deducting from the gross amount of the income received within the year from all sources "interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded or other indebtedness not exceeding the paid-up capital stock of such corporation, * * * outstanding at the close of the year, * * *."

There is nothing in the language of the clause quoted above that justifies the conclusion that Congress intended that premiums on stock sold by a corporation should be added to its outstanding paid-up capital stock in determining the deduction to be made in assessing the tax. It follows, therefore, that interest paid by a corporation on a sum representing premiums received from sale of its stock can not be deducted in ascertaining the net income of such corporation.

Section 234, Article 561: Allowable deductions. 23–19–550. T. D. 2927.

RULING UNDER REVENUE ACT OF 1909.

SPECIAL EXCISE TAX ON CORPORATIONS—DECISION OF COURT.

Deductions from gross income—Taxes paid on behalf of corporations.—Taxes paid to a State by various corporations upon shares of their stock owned by another corporation are not deductible from gross income of this latter corporation as taxes "paid by it," such taxes being not paid by this corporation, but being paid in its behalf by other corporations.

The appended decision of the United States District Court for the District of Connecticut in the case of the United States *v.* Aetna Life Insurance Co. is published for the information of internal-revenue officers and others concerned.

UNITED STATES DISTRICT COURT, DISTRICT OF CONNECTICUT.

United States, plaintiff, *v.* Aetna Life Insurance Co., defendant.

GARVIN, Judge: This action is submitted to the court for determination upon an agreed state of facts. It appears that the defendant, an insurance company incorporated under the laws of the State of Connecticut, was subject to pay annually during the years 1909, 1910, and 1911, with respect to the carrying on and doing of its business, the excise tax imposed by section 38 of the act of Congress approved August 5, 1909, and was subject in all respects to the provisions of that section.

On or before March 1 in each of these years the defendant duly made its return to the collector of internal revenue in the proper district in the form prescribed by the Commissioner of Internal Revenue as required by said section, which returns showed that the net income of the defendant for each of these three years exceeded $5,000.

On or about June 1 of the years 1910, 1911, and 1912 an excise tax under said act was duly assessed against the defendant for the years ending December 31, 1909, 1910, and 1911, respectively, said tax being 1 per cent on the net income of the defendant. The tax was in each case paid as assessed.

When the defendant filed its return showing its net income for the year ending December 31, 1909, it deducted $479,625 as "taxes paid during the year ending December 31, 1909, imposed under authority of the United States or States and Territories thereof." Of this sum it is conceded that $409,967.36 was lawfully deducted. It is claimed by the plaintiff that defendant should also have paid a tax of 1 per cent on the remainder, $69,637.64, i. e., $696.56. Of the latter sum defendant admits liability to the extent of $227.62, leaving $468.96 in dispute. The amount admitted for 1910 is $343.17, $413.41 being in dispute. For 1911, $543.28 is admitted, $527.60 being in dispute. These sums in dispute represent taxes paid by various corporations upon shares of their stock owned by defendant, which taxes were imposed during the several years 1909, 1910, and 1911 by the State of Connecticut under chapter 54 of the public acts of 1905.

The deductions allowed a corporation by the act of August 5, 1909, include "all sums paid by it within the year for taxes imposed under authority of the United States or of any State or Territory thereof, or imposed by the Government of any foreign country as a condition to carry on business therein." The taxes in question were not paid by the defendant, but in its behalf by other corporations.

While it is true that "a statute providing for the imposition of taxes is to be strictly construed, and all reasonable doubts in respect thereto resolved against the Government and in favor of the citizen" (Mutual Benefit Life Insurance Co. *v.* Herold, 198 Fed., 199, and cases therein cited), no doubtful meaning is here involved. The language of the act is clear and explicit. The allowable deductions in the case of a domestic corporation are plainly set forth.

" Deductions allowed from gross income in the case of a domestic corporation:

" Second. Such net incomes shall be ascertained by deducting from the gross amount of the income of such corporation, joint stock company or association, or insurance company, received within the year from all sources—

"(First) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rental or franchise payments, required to be made as a condition to the continued use or possession of property;

"(Second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other than dividends paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds;

"(Third) interest actually paid within the year on its bonded or other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association, or trust company, all interest actually paid by it within the year on deposits;

"(Fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the Government of any foreign country as a condition to carry on business therein;

"(Fifth) all amounts received by it within the year as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed."

If it had been the intention to permit such a deduction as defendant urges, the act would have provided that there be included "all sums paid by it or in its behalf within the year."

Defendant relies upon a decision by the Treasury Department rendered March 24, 1916, reading in part:

"You are advised that when a corporation pays taxes for its stockholders, such payments represent a portion of the earnings of the corporation, which instead of being distributed to the stockholders in the form of dividends is used in payment of taxes which the stockholders individually owe. Should you instead of paying the taxes, pay over this sum to the stockholders, the stockholders would be required to return the amount as income received, and would then be entitled to deduct the same under the item of taxes paid during the year. Under the excise tax law a stockholder which is a corporation is entitled to deduct from gross income all dividends received from another corporation subject to tax, and therefore is entitled to deduct as a dividend that portion of the earnings of the corporation in which it owns stock, which is represented by the stockholder's tax. For the years 1909 to 1912, inclusive therefore, the corporation which is a stockholder will be entitled to an additional deduction on account of the taxes paid for it by the corporation issuing the stock, for the reason that it produces the same result as if the corporation owning the stock was required to return as income for these years the full amount of the dividend, including that portion of the dividend diverted to pay tax, and then took credit as a deduction for this entire amount under the item of dividends received from other corporations, and also took credit for the amount of taxes paid under that item. Under the income-tax law, however, a corporation is not entitled to deduct from gross income dividends received from other corporations. Consequently if it claims the benefit of deducting from gross income taxes paid for it by another corporation it must include such amount in income as the deduction counterbalances the receipt. As you, the stockholder in this case, did not return as income the amount in question, you are not entitled under the income-tax law to deduct the same. The claim on account of the tax assessed for the year 1913 is accordingly rejected, and you will find inclosed notice of demand for payment of this tax.

"The claim for the abatement of the additional tax assesed for 1912 has received favorable consideration for the reason above stated."

This decision points out that a corporation making a claim such as is advanced by defendant must have included in its return as income the taxes which were paid in its behalf by other corporations. No such return was made by defendant herein, therefore the decision is not in point even if it were controlling on the court.

There was no refusal or neglect to make a return within the meaning of the act and therefore no penalty will be allowed.

Judgment for plaintiff for $2,524.04, with interest from June 9, 1915.

Section 234, Article 561: Allowable deductions. 27–19–604. T. D. 2944.

Southern Pacific R. R. Co. *v.* Muenter (C. C. A., Oct. 6, 1919). Deduction under section 38, Act of August 5, 1909, of discount on bonds sold.

Where a corporation sold bonds at a discount during 1906, 1907, and 1908, no deduction from gross income for the years 1909, 1910, and 1911 of sums set aside by the corporation to pay such discount at the maturity of the bonds is permitted under the provisions of section 38, act of August 5, 1909, authorizing corporations to deduct from gross income "(second) all losses actually sustained within the year * * *" and "(third) interest actually paid within the year on its bonded or other indebtedness * * *." Baldwin Locomotive Works *v.* McCoach (221 Fed., 59) explained.

The appended decision of the United States Circuit Court of Appeals for the Ninth Circuit in the case of Southern Pacific Railroad Company *v.* Muenter, is published not as a ruling of the Treasury Department, but for the information of internal-revenue officers and others concerned.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT, NOS. 3286 AND 3287. TERM, 1919.

Southern Pacific Railroad Company, a corporation, plaintiff in error, *v.* August E. Muenter, formerly collector of internal revenue et al., defendants in error. (In error to the United States District Court for the Northern District of California.)

Before Gilbert, Ross, and Hunt, circuit judges.

GILBERT. Circuit Judge: The court below sustained a demurrer to the complaint brought by the plaintiff in error to recover certain items of corporation income tax paid under protest upon its net income for the years 1909, 1910, and 1911. The complaint alleged that during the years 1906, 1907, 1908, the plaintiff in error borrowed various sums of money, and as security therefor issued and sold interest-bearing bonds of the par value of $1,000, drawing interest at 4 per cent per annum, and maturing on the 1st day of January, 1955, which bonds it was necessary to sell at a discount. The amount involved in the action is the sum of $1,392.22, income tax upon reserved sums of money which the plaintiff in error had set aside as the pro rata amount of the discount for the years in question distributed over the entire period until the maturity of the bonds, the plaintiff in error contending that the discount is to be regarded as a portion of the interest which it pays upon the loans. The question presented is whether or not money so reserved and set aside by book entries to meet the final payment of the discount could be deducted from net income of the corporation under the income tax law of 1909 (36 Stat., 102, sec. 38). That act, so far as it pertains to this question, provides that the net income upon which the tax is to be assessed is ascertained by deducting from the gross income, (second) all losses actually sustained within the year and not compensated by insurance or otherwise, (third) interest actually paid within the year on its bonded or other indebtedness.

The plaintiff in error refers to Baldwin Locomotive Works *v.* McCoach (215 Fed., 967), and the same case on appeal (221 Fed., 59), as sustaining its contention. In that case the bonds were 31-year bonds, and the assessor thought it proper to deduct 1/31 of the total discount from the gross income of each taxable year. The controverted question in the case, however, was whether or not the corporation could deduct for the year 1910 the total discount upon the bonds which they had sold at 5 per cent discount. The court held that a book charge because of the sale of an issue of bonds at less than par is not a part of the "expenses actually paid within the year out of income" so as to be deducted from gross income. There was no discussion of the question whether 1/31 part of the total discount deducted for the year had been deducted lawfully, as that deduction was not involved in the controversy. We think the present case is determined adversely to the plaintiff in error by the plain language of the statute. The money set apart upon the books each year until the maturity of the bonds to meet the loss which came from selling the bonds below par was the application of a prudent and proper system of business, and was a wise provision for the future, but it was not the payment of interest, nor did it represent a loss actually sustained within the year. The money was not in fact paid out. Notwithstanding the books of the plaintiff in error, the money is still in its possession, and subject to its control. A system of bookkeeping will not justify the Government in claiming taxes, nor will it justify the taxpayer in claiming exemption from taxation. The facts must control. Baldwin Locomotive Works *v.* McCoach (221 Fed., 59); Mitchell Bros. *v.* Doyle (225 Fed., 437).

The judgment is affirmed.

Section 234, Article 561: Allowable deductions. 3–19–188.
(Also Section 204, Article 1601.) S. 983.
(Also Section 214 (a) 1, Article 111.)

SUM PAID FOR RELEASE FROM PURCHASE CONTRACT.

Where a corporation pays liquidated damages in 1919 to be relieved from the terms of a contract which called for the delivery of goods in 1918 and 1919, the loss so incurred is deductible from gross income for the year 1919 rather than 1918. Applicability of section 204(b), Revenue Act of 1918, discussed.

The question under consideration is whether a sum paid in 1919 by a company to be relieved from a contract for delivery of goods in 1918 and 1919 is deductible in 1918, the year in which the matter was negotiated, though the final agreement and adjustment and payment was not made until 1919.

Section 234(a) (4), Revenue Act of 1918, provides:

> That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> Losses sustained during the taxable year and not compensated for by insurance or otherwise.

For losses sustained in any taxable year to be deductible they must be evidenced by closed and completed transactions. Regulations 45, article 141 (preliminary edition).

With respect to losses arising from theft or casualty, this office has held that the loss is a legal deduction from the gross income of the year in which the theft or casualty actually occured.

Then, too, this office has held that a fire insurance company was not entitled to deduct from its gross income losses incurred upon its policies of insurance unpaid at the end of the year. The loss has been allowed as a deduction from gross income of the year in which the loss was paid. In Law Opinion 777 it was held that when the amount of a loss arising from the failure to deliver munitions in 1916 was not determined until 1917, such loss was deductible in 1917. In the opinion it was said:

> Where a company is sued for some tort committed by its employees or on account of some accident the loss is generally allocated to the year in which the judgment is rendered against the company. No loss is recognized until final judgment is rendered. This is true of railroads required to keep accounts in accordance with regulations of the Interstate Commerce Commission and it is also true of most manufacturing corporations. If it were not so the accounting for any given year would not be completed until many years afterwards, and if this office were to proceed upon the theory that every loss must be charged back against the income of the year in which the operation occurred giving rise to the loss, the administration of the taxing acts would be an interminable accounting proposition.

In the present case the amount to be paid for the cancellation of the contract was not determined nor paid until 1919. The loss was not a *closed* and *completed* transaction until that time. Negotiations were entered into in 1918, but the final outcome of the same or the amount to be paid as liquidated damages, was not, and from the nature of things would not be, known until the final agreement and adjustment had been made.

If it should appear that the company has sustained a net loss from operation for the year 1918 by reason of the production of articles contributing to the prosecution of the war, section 204(b) may be availed of. The amount of net loss claimed must represent an actual net loss over and above all income, including tax-free income. Regulations 45, article 1601.

It is held that where a corporation pays liquidated damages in 1919 to be relieved from the terms of a contract which called for the delivery of goods in 1918 and 1919, the loss so incurred is deductible from gross income for the year 1919 rather than 1918.

Section 234, Article 561: Allowable deductions. 20-19-515.
S. 1145.

EXCISE TAX, SECTION 38, ACT OF AUGUST 5, 1909; INCOME TAX, PARAGRAPH G (B), ACT OF OCTOBER 3, 1913.

Deductions.—Payments to trustees by a cemetery company, during the taxable year, of a percentage of the proceeds of sales of cemetery lots set aside for a "maintenance fund" to be controlled solely by the trustees thereof pursuant to a provision in the charter of the company requiring such payments, are not deductible from the gross income of the corporation under the Act of August 5, 1909, and the Act of October 3, 1913.

The question arises as to the deductibility by a company of the payments of moneys to trustees for a "maintenance fund" under the following statutes:

Section 38, Act of August 5, 1909, provides that corporations may deduct from gross income:

* * * (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges, such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property.

Paragraph G (*b*), Act of October 3, 1913, contains a provision which is almost verbatim:

* * * (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property.

The charter of the M Cemetery Co. provided that a fund to be known as the "care fund" be created by the directors by setting aside a certain percentage from the proceeds of sales of cemetery lots; the interest and income arising therefrom to be used in "the maintenance, upkeep, or improvement of the company's cemetery grounds." Provisions were made for the annual election of three or more trustees by the stockholders, which trustees were to be custodians of the "care fund," with absolute control as to the investment thereof and the expenditure of the income therefrom through the board of directors of the company. Following the incorporation of the company, sales were made during the years 1910-1914, inclusive, and 10 per cent of the proceeds of such sales were set aside by the board of directors as provided in its articles of incorporation.

The specific question arises as to whether the 10 per cent of the proceeds of the sales of lots by the company which were thus set aside are proper deductions under the terms of the statute.

It can not be said that the percentages of sales of cemetery lots set aside and paid to trustees to create a perpetual maintenance fund can be considered "ordinary and necessary expenses paid within the year in the maintenance and operation of its business and property." It is obvious that the payments were made for the creation of a fund which is designed to provide an income for the maintenance of the properties of this company during future years.

It is not believed that the payments can be considered as "charges" or "payments" contemplated by the statute "required to be made as a condition to continued use or possession of property." Such "charges" or "payments" are of a character required to be made to some one other than the corporation and to which the corporation thereafter has no right or expectancy of benefit. In the instant case the payments are made to create a fund, the sole benefit of which is to inure to the corporation in future years. Except for the fact that these payments pass to the control of trustees who are to administer the same in a trust fund for the benefit of the corporation, the transaction does not differ materially from reserves set aside by any corporation from its yearly receipts for the future maintenance and care of its property. As has been aptly said, it is a "question merely of taking the money out of one pocket and putting it into the other."

In Solicitor's Memorandum No. 155 there was considered a pension fund for the benefit of employees of a corporation which was to be created by contribution thereto by the corporation and the contribution of a certain percentage of the salaries of its employees. It was there held that in view of the fact that the fund remained under the absolute control of the company, that it was to be taxed as a branch of the taxpayer's business, and that the payment to the trustees by the corporation could not be regarded as "ordinary and necessary expenses paid within the year in the maintenance and operation of its business or property." From this opinion it would seem that the holding might be otherwise, provided the beneficiaries of the fund were given a voice in the administration of the fund and provided the expenditures could properly be classed as "expense" as distinguished from capital expenditure. In the instant case, although the payments pass out of the control of the corporation to trustees, yet the fund is held by the trustees for the benefit of the corporation and, as in the case considered in Solicitor's Memorandum No. 155, the fund is in effect a branch of the business of the cemetery company.

It is therefore held that:

Payments to trustees by a cemetery company, during the taxable year, of a percentage of the proceeds of sales of cemetery lots set aside for a "maintenance fund" to be controlled solely by the trustees thereof pursuant to a provision in the charter of the company requiring such payments, are not deductible from the gross income of the corporation under the act of August 5, 1909, and the act of October 3, 1913.

Section 234, Article 561: Allowable deductions. 10–19–362.
(Also Section 214 (a), Article 105.) T. B. M. 44.

The problem of determining reasonable compensation for personal services is one of difficulty, in that there are few general rules which can be laid down as guides to a decision. Many factors are involved, among them being the character and amount of responsibility, ease or difficulty of the work itself, time required, working conditions, future prospects, living conditions of the locality, individual ability, technical training, profitableness to the employer of the services rendered, and the number of available persons capable of performing the duties of the position. These and other factors have a bearing, and the amount of weight to be attached to each one can be determined only in the light of the circumstances in each particular case.

Section 234, Article 561: Allowable deductions. 3–19–201. O. D. 130.

A domestic corporation will not be required to pay income, excess profits, and war profits taxes on dividends received from a foreign holding company whose income was derived entirely from dividends on the stock of another domestic company.

Section 234, Article 561: Allowable deductions. 4–19–228. O. D. 146.

A corporation keeping its accounts on an accrual basis will not be permitted to deduct from gross income a sum in anticipation of the amount the corporation may be required to allow as cash discount on accounts due and payable in the succeeding year. But any amounts so allowed in the succeeding year before the return is filed may be deducted from gross sales for the previous taxable year.

Section 234, Article 561: Allowable deductions. 16–19–464. O. D. 259.

Machinery, equipment, or other facilities erected or acquired on or after April 6, 1917, for the production or manufacture of sugar is considered as contributing to the prosecution of the war, and the cost may be amortized in accordance with the provisions of section 234 (a) (8) of the Revenue Act of 1918.

Section 234, Article 561: Allowable deductions. 22–19–537. O. D. 288.

A reserve fund created out of the earnings of a corporation for the purpose of redeeming its preferred stock is not an allowable deduction in computing the net income of the corporation for tax purposes.

Section 234, Article 561: Allowable deductions. 14–19–438.
(Also Section 239, Article 621.) M. 2207.

In order to obviate the necessity of filing amended returns by corporations which filed their completed returns prior to the publication of the opinion of the Attorney General and claimed deductions on account of contributions to the Red Cross and other recognized war organizations, corporations which filed their returns and claimed such deductions prior to the issuance of Treasury Decision 2847, should immediately file with the collector of internal revenue a statement showing the amount of such deductions claimed, the amount of the net income as reported and as corrected, and the amount of additional tax due by reason of the erroneous claiming of the deduction. The total amount of additional tax shown to be due by this corrected statement should be paid at once, together with interest on the first and second installments thereof from the original due dates.

In cases where the above procedure is followed, amended returns will not be required, and the statements referred to when received by the collectors' offices or when received through the collector by this office will be filed with the original returns in lieu of an amended return.

Section 234, Article 561: Allowable deductions.

(See 5–19–251, sec. 214 (a) 12, art. 261.) Losses in inventory and from rebates.

Section 234, Article 561: Allowable deductions.

(See 5–19–252, sec. 216, art. 301.) Taxability of dividends received from foreign corporations deriving income from sources within the United States.

Section 234, Article 561: Allowable deductions.

(See 11–19–377, sec. 214 (a) 1, art. 101.) Premium on crop insurance an allowable deduction.

Section 234, Article 561: Allowable deductions.

(See 13–19–418, sec. 214, art. 131.) Deduction of additional excise taxes assessed against a corporation under the Revenue Act of 1909 and paid during subsequent years.

Section 234, Article 561: Allowable deductions.

(See 17–19–469, sec. 201, art. 1544.) Dividends paid in Liberty bonds having a market value less than par.

Section 234, Article 561: Allowable deductions.

(See 17–19–471, sec. 214 (a) 12, art. 261.) Inventory loss by partnership succeeding a corporation.

Section 234, Article 561: Allowable deductions.

(See 22–19–534, sec. 214, art. 105.) Salaries voted subsequent to the close of taxable year.

Section 234, Article 561: Allowable deductions.

(See 23–19–551, sec. 250, art. 1002.) Penalties added to tax: When deductible as business expense.

Section 234, Article 561: Allowable deductions.

(See 24–19–561, sec. 214, art. 133.) Assessments under Illinois laws relating to drainage districts.

Section 234, Article 561: Allowable deductions.

(See 26–19–595, sec. 250, art. 1003.) Deduction of interest on taxes.

Section 234, Article 561: Allowable deductions.

(See 26–19–597, sec. 301, art. 715.) Amortization when part of income is from Government contracts.

Section 234, Article 562: Donations. 4–19–229.
T. D. 2847.

INCOME TAXES.

Corporations are not entitled to deduct from gross income the amount of contributions to religious, charitable, scientific, or educational corporations or associations, even though such contributions may be made to Red Cross or other war activities.

The Revenue Act of 1918 contains two sections relating to deductions which may be made in ascertaining net income subject to tax. Section 214 relates to individuals and allows as deductions (1) all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, etc.; (2) all interest paid or accrued within the taxable year on indebtedness, etc. (with certain exceptions); (3) taxes paid or accrued within the taxable year, etc. (with certain exceptions); (4–10) certain allowance for losses, bad debts, exhaustion, wear and tear of property of various sorts; (11) contributions or gifts made within the taxable year to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, etc.

Section 234 relates to corporations, and allows as deductions (1) all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken, or is not taking title, or in which it has no equity; (2) all interest paid or accrued within the taxable year on its indebtedness (with certain exceptions); (3) taxes paid or accrued within the taxable year. etc. (with certain exceptions); (4 et seq.) losses sustained of a certain character, bad debts, allowances for exhaustion, wear and tear, etc.

The question is presented whether corporations are entitled to deduct from their gross income for the purpose of the income tax the amount of contributions to religious, charitable, scientific, or educational corporations or associations, this question arising most frequently with reference to contributions made to the Red Cross and other war activities.

It will be observed that there is no express deduction permitted corporations of such contributions, as in the case of individuals, and unless, therefore, they fall within the definition of some item of deduction allowed to corporations they can not be allowed. The only head within which it might be suggested that such contributions could be included is that of ordinary and necessary expenses paid or incurred in carrying on any trade or business, including reasonable salaries or other compensation, rentals, and payments for use of property provided for in paragraph 11. Practically these same deductions are permitted in section 214 in the case of individuals, and had such words included the contributions or gifts mentioned in paragraph 11 of section 214, it would have been unnecessary to put in such paragraph, as they would have been covered by paragraph 1 of such section.

The Attorney General, in an opinion dated May 19, 1919, states the view that ordinary and necessary expenses contemplated by paragraph 1 of sections 214 and 234 were not intended to include all necessary expenses, because the two immediately succeeding paragraphs provide for deducting interest and taxes, both of which are necessary expenses; also the provision in regard to allowance for salaries, compensation, rentals, etc., indicates that all of the expenses which are contemplated under the terms used in paragraph 1 of these sections are expenses incurred directly in the maintenance and operation of the business, and not all those which may be beneficial and even necessary in the broader sense.

In addition to the above considerations and to the fact that there is express provision for deducting contributions or gifts in the case of individuals, which is wanting in the section providing for deductions to be made by corporations, reference to the legislative history of the Revenue Act of 1918 (Congressional Record for Sept. 17, 1918), shows that an amendment providing that corporations might make deductions of contributions or gifts, as in the case of individuals, came to a vote and was defeated, the principal reason assigned in the debate being that it would be dangerous to authorize directors to be generous with the money of their stockholders even for such laudable purposes.

Corporations are therefore not entitled to deduct from their gross income for the purposes of the income tax the amount of contributions made to religious, charitable, scientific, or educational corporations or associations, even though such contributions are made to the Red Cross or other war activities.

Section 234, Article 562: Donations. 2–19–164.
S. 965.

A corporation may not deduct the amount paid into a pension fund for the benefit of its employees in the taxable year. This rule obtains although the corporation constitutes itself a trustee of the sum contributed to pay the income thereof to its employees, but reserves absolute discretion as to the selection of the employees to be benefited.

Section 234, Article 562: Donations. 2–19–165.
O. D. 110.

Donations by a corporation to a pension fund for the benefit of its officers and employees, the fund being organized entirely separate and distinct from the corporation, having its own set of books, making its own investments, and paying its own expenses, legal title of which does not remain in the corporation, are deemed to be donations to a charitable institution conducted for the benefit of the corporation's employees or their dependents representing a consideration for a benefit flowing directly to the corporation as an incident of its business and are allowable deductions from gross income in determining net income subject to tax.

Section 234, Article 563: Sale of capital stock, bonds, and capital assets. 2–19–166.
O. D. 111.

A corporation which issued its bonds at a discount and improperly charged the discount to profit and loss may correct its books to show the discount treated as interest paid in advance to be amortized over the life of the bonds. Amended returns reflecting correction in the books may be filed.

Section 234, Article 566: Tax on bank stock. 7–19–302.
O. 858.

DEDUCTIBILITY OF TAXES PAID FOR CORPORATION BY BANKS ON SHARES OF STOCK OWNED BY CORPORATION.

Where a corporation is a stockholder in a bank or other corporation which is required by law to pay taxes assessed on the value of its shares of stock in the hands of the holders or owners, the stockholder corporation may deduct the amount paid on its behalf, but such taxes are considered additional dividends and must be included in dividends received if the tax is allowed as a deduction in computing net income.

The question is asked whether corporations (including national banks) which own shares of stock of a national bank are permitted to deduct as taxes the amount paid by the latter on their share holdings, the tax being assessed on the value of shares in the hands of the holders, but as a matter of convenience is collected through the bank.

Section 234(a) of the Revenue Act of 1918 provides:

That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(3) Taxes paid or accrued within the taxable year * * *.

Where a State imposes a tax upon the value of shares of stock in the hands of the holders or owners and requires the corporation issuing the stock to pay the tax, the amount paid is not deductible in computing the taxable income of the corporation. See Solicitor's Memoranda 707 and 922. The shares of stock are property of the stockholders, and to the extent that the taxes assessed on the value of the shares of stock are property taxes the holders are primarily liable for their payment. In such case a corporation simply pays the tax for the stockholders.

In T. D. 2135 it was held:

Taxes assessed against the stockholders of a bank and paid by the bank in behalf of the stockholders do not constitute an allowable deduction from the gross income of the bank, but do constitute an allowable deduction in the return of the individual. If such individual is subject to the additional tax, the amount of taxes so paid should be included in his return as income, the said amount being considered as an additional dividend to the amount of the taxes paid.

If an individual stockholder is allowed to deduct the amount of taxes paid by a corporation in his behalf, there is no good reason why a corporation holding and owning stock in a bank or other corporation should not also be allowed to deduct the amount of taxes paid in its behalf.

Article 566, Regulations 45, provides that—

Banks paying taxes assessed against their stockholders on account of their ownership of the shares of stocks issued by such banks can not deduct the amount of taxes so paid * * *. Such payments by banks or other corporations are regarded as in the nature of additional dividends and must be included by the stockholder in his dividends received if he deducts the taxes paid on his behalf.

It is not clear whether corporations which own stock in a bank or other corporation are within the rule stated in article 566. However, there is no intention to discriminate between individuals and corporations in the matter of deducting taxes except where it is otherwise expressly provided, as appears from the provisions of article 565, Regulations 45, which read as follows:

Corporations may deduct taxes from gross income to the same extent as individuals, except that in the case of corporate bonds or obligations containing a tax-free covenant clause, the corporation paying a Federal tax, or any part of it, for some one else pursuant to its agreement, is not entitled to deduct such payments from gross income on any ground * * *.

It is therefore held that where a corporation is a stockholder in a bank or other corporation which is required by law to pay taxes assessed on the value of its shares of stock in hands of the holders or owners, the stockholder corporation may deduct the amount paid on its behalf, but such taxes are considered additional dividends and must be included in dividends received if the tax is allowed as a deduction in computing net income. Under the Revenue Act of 1918 amounts received by a stockholder corporation as dividends from another corporation which is taxable upon its net income are also allowable deductions. (See sec. 234(a) (6).)

Section 234, Article 566: Tax on bank stock. 1–19–99.
O. D. 70.

Trust companies, building and loan associations, and State savings banks organized under the laws of the State of Oregon are not allowed to deduct from gross income taxes paid upon the value of their shares of stock.

Section 234, Article 566: Tax on bank stock. 9–19–344.
O. D. 199.

Article 566 of Regulations 45 has special reference to individual stockholders, but is equally applicable in the case of corporation stockholders.

Section 234, Article 569: Required addition to reserve funds of insurance companies. 1–19–96.
O. 799.

NET ADDITION TO RESERVE FUNDS OF LIFE INSURANCE COMPANIES.

A life insurance company which maintains a reserve to liquidate coupons left with the company to accumulate at interest and accrued interest thereon is entitled to deduct from gross income in its annual tax returns the net addition made each year to such fund.

The X Life Insurance Co. has on file claims for the refunding of corporation income taxes paid under the Revenue Acts of 1913 and 1916. It bases its claims for a refund upon the fact that it should have been allowed deductions from gross income for the increases of the policy coupons left with it to accumulate at interest. It reported for these years to the insurance department a separate item among its liabilities as follows:

Coupons left with the company to accumulate at interest and accrued interest thereon.

It contends that this is a part of its policy contract and is a statutory reserve. It appears that there are a number of life insurance companies issuing this form of a policy, and the question of whether such companies have the right to deduct from gross income in their annual tax returns the net addition made each year to the fund maintained for meeting this liability, is an open and much debated one.

The income tax law of October 3, 1913, and also that of September 8, 1916, allow an insurance company to deduct from gross income among other items:

> The net addition, if any, required by law to be made within the year to reserve funds.

Article 147(d) of Regulations No. 33 and article 240 (par. 695) of Regulations No. 33, revised, provide what reserves shall be considered legal reserves of life insurance companies. In the earlier regulations it was provided that only the reinsurance reserve and reserve for supplementary contracts were to be considered as reserves required by law. In the later regulation it was held that the net addition to these and also to such other reserves as are specifically required by the statutes of the State within which the company is doing business will be allowed as deductions.

In Solicitor's Memorandum No. 647 it was held that the Y Life Insurance Co. was entitled to deduct from gross income in its income tax returns the net addition made to its reserves maintained against premium reduction coupons not used and guarantee dividend fund.

This opinion is controlling in the present case. The X Life Insurance Co. is required to maintain a reserve against its coupons and accrued interest thereon. This requirement is in accordance with the provisions of a State statute. The net addition to the fund maintained for the payment of the coupons is a legal deduction from gross income.

Section 234, Article 569: Required addition to reserve funds of insurance companies. 3–19–202. O. 815.

> A law requiring casualty insurance companies to establish certain reserves is to be construed as applying to companies issuing exclusively health and accident policies, unless the terms of the law are such as to indicate they are not to be included in that term, or unless they are held not to be included in that term by the courts of the jurisdiction in which that law was promulgated.

Opinion is requested upon the questions: (1) Whether the X Company and other insurance companies which write only personal accident and health policies, are casualty insurance companies, and (2) whether such insurance companies should be allowed the same deduction from gross income, in determining their corporation excise and income taxes, as has been allowed companies issuing liability, burglary, flywheel, and workmen's compensation policies and maintaining, under requirements of the statutes of various States, special reserves for unpaid liability and compensation claims.

Section 38 of the Act of August 5, 1909, provides as follows:

> Second. Such net income shall be ascertained by deducting from the gross amount of the income of such * * * insurance company, received within the year from all sources, * * * all losses actually sustained within the year and not compensated by insurance or otherwise, including * * * the net addition, if any, required by law to be made within the year to reserve funds.

Section II, G (b) of the Act of October 3, 1913, contains the same provision.

The particular occasion for these queries is that the X Company, which writes only personal health and accident policies, has filed a claim for refund on the ground that it is a casualty insurance company, and, as such, was entitled to deduct from its gross income net additions to reserve funds for 1909 to 1915, inclusive. In the case of any insurance company net additions to reserve funds are not deductible unless they are required by law. Statutes of several States, however, provide that "casualty insurance companies" shall maintain a special reserve to cover unpaid claims. (See Pennsylvania Statute, 1 June, 1911, sec. 7, P. L. 607–622.) In the past the deductions for net additions to reserve funds covering unpaid losses have been allowed to insurance companies which write policies covering loss by damage to property, on the ground that they were "casualty insurance companies," and therefore required by these State statutes to maintain such reserve funds; but the adjustment based on these statutes has not been extended to other insurance companies, because they have not been considered "casualty insurance companies." The claim of the X Company raises the question whether insurance companies issuing only personal health and accident policies are not included in the class of "casualty insurance companies" required by these statutes to maintain special unpaid claim reserves, and, therefore, entitled to the same deduction.

(1) There has been a slight tendency of the courts to recognize the existence of casualty insurance as distinguished from accident and other kinds of insurance. The few decisions upon the subject are, however, hopelessly in conflict as to what constitutes such insurance. In State (ex rel. Clapp) *v.* Federal Investment Co. (42 Minn., 110; 50 N. W., 1028) the term is said to have "a well-defined meaning as insurance against loss through accident resulting in bodily injury or death." The court did not have occasion to decide whether insurance against loss to property might be included in the same class, but this decision seems to be authority for the proposition that personal accident insurance is covered by the term "casualty insurance." In Employers' Liability Assurance Corporation *v.* Merrill (155 Mass., 404; 29 N. E., 529) a different view is taken. The court said:

> The distinguishing feature of what is known in our legislation as "accident insurance" is that it indemnifies against the effects of accidents resulting in bodily injury or death. Its field is not to insure against loss or damage to property, although occasioned by accident. So far as that class of insurance has been developed, it has been with reference to boilers, plate glass, and perhaps to domestic animals, and injuries by street cars, and is known as "casualty insurance."

This is a mere dictum, however, unnecessary, for the decision of the case, which was that certain policies were personal accident policies. In Bankers' Mutual Casualty Company *v.* First National Bank (131 Iowa, 456; 108 N. W., 1046) the court, without disapproving the definition of the Minnesota court, held it inapplicable to the Iowa statute, which spoke of insurance against loss by fire and "other casualties." The statute clearly referred to property loss, as opposed to personal injury or death. The court remarked that "'casualty' and 'casualty insurance' are words of quite frequent use, yet it can not be said that their definition has been very accurately settled by the courts." This remains true. Only the Massachusetts case distinguishes casualty insurance from accident insurance. Statutes of several States define "casualty insurance on assessment plan" as applicable to accidental death or physical disability from accident or sickness.

A typical statute in Pennsylvania enacted in 1911 (1 June, 1911, sec. 1; P. L., 567, 581) provides for the organization in that State of casualty insurance companies. They are permitted to organize for any of 11 enumerated purposes, including the following:

> Two.—To insure against injury, disablement, or death resulting from traveling or general accident, and against disablement resulting from sickness, and every insurance appertaining thereto, including a funeral benefit to an amount not exceeding one hundred dollars.

The various other classes include fidelity, plate glass, compensation, steam boiler, flywheel, pipe, engine, machinery, burglary, theft, credit or guaranty, breakage or leakage of sprinklers, pumps, water pipes or plumbing, accident to elevators, bicycles, automobiles, and vehicles (except rolling stock of railways), horse, cattle, and other live-stock insurance, concluding with:

> Eleven.—To insure against loss by any other casualty not included under the foregoing heads, except life, fire, marine, or title insurance, which may be a proper subject of insurance.

No distinction is made in Best's Insurance Report for 1918 between companies writing policies covering personal accidents and sickness and companies writing policies covering loss by accident damaging property. Both are considered under the head of casualty insurance companies.

There appears to be no reason to distinguish personal accident and health insurance companies from casualty insurance companies. A personal accident is a casualty within the ordinarily accepted meaning of that term. Webster's International Dictionary defines casualty as "that which comes without design or without being foreseen; contingency; any injury of the body from accident." "Casualty insurance" is not a technical, legal, or trade term meaning insurance against accidents to property. In common parlance the term means insurance against all kinds of accidents and injuries.

It is concluded that no legal distinction exists between insurance companies issuing policies of insurance against accidents and sickness resulting in bodily injury, disablement, or death, and companies issuing policies of insurance against loss or damage to property through accident, both being included in the class of casualty insurance companies.

(2) Since laws of certain States—of which the Pennsylvania statute is an illustration (1 June, 1911, sec. 7 P. L. 607–622)—provide that casualty insurance companies maintain a special reserve against unpaid claims, and it has been determined that insurance companies issuing only "personal health and accident" policies are casualty insurance companies, a law requiring casualty insurance companies to establish certain reserves is to be construed as applying to companies issuing exclusively health and accident policies, unless the terms of the law are such as to indicate they are not to be included in that term, or unless they are held not to be included in that term by the courts of the jurisdiction in which that law was promulgated.

Section 235.—ITEMS NOT DEDUCTIBLE.

Section 235, Article 581: Items not deductible.

(See 11–19–391, sec. 326, art. 831.) Commissions on sale of stock.

Section 236.—CREDITS ALLOWED.

Section 236, Article 591: Credits allowed.

(See 23–19–551, sec. 250, art. 1002.) Amounts added to tax as penalties not to be considered as credits.

Section 237.—PAYMENT OF TAX AT SOURCE.

Section 237, Article 601: Withholding in the case of nonresident foreign corporations. 7–19–303. T. B. R. 29.

Liability of the X Company to withhold tax on share of profits paid as royalty or rental to a foreign corporation.

The X Company is manufacturing and selling a product on which a foreign corporation, the Z Company, holds the patent rights. The American company, in consideration of these patent rights, agreed to pay to the foreign corporation a specific royalty on sales and in addition a portion of the net profits arising from the business. The American corporation has presented to the collector its view that the 10 per cent tax should be withheld on the specific royalty but not on the amount which represents the share of the foreign corporation in the earnings of the American corporation.

Without doubt, under the provisions of sections 221 and 237 of the Revenue Act of 1918, the 10 per cent tax should be withheld upon the specific royalty. The question at issue is whether the amount constituting the portion of the net profits of the business after deducting Federal income and excess profits taxes which by contract is to be paid by the American corporation to the foreign corporation, is subject to such withholding, and the answer depends upon the nature of the payment.

Three views as to the nature of the payment are conceivable: (1) That it is a distribution of the profits of a joint enterprise carried on by the American corporation and the foreign corporation; (2) that it is a distribution of profits as such of the American corporation to the foreign corporation; and (3) that the payment is compensation—royalty—for the use of the patent.

The view that the payment is a distribution of the profits of a joint enterprise is untenable. In a sense there is a joint enterprise. There is, however, no taxable entity of which the two corporations are members. They are not partners. Nor do they constitute an association within the meaning of the statute. They can not even file a consolidated return as affiliated corporations. The profits to be distributed are profits of the American corporation which it has agreed to pay to the foreign corporation.

The view that the payment is a distribution of profits as such of the American corporation to the foreign corporation is equally untenable. The only form of distribution of profits as such of a corporation recognized by the statute is a dividend. A dividend is defined as a distribution out of earnings or profits to the "shareholders or members" of the corporation. (See sec. 201 (a).) In no sense is the foreign corporation a shareholder or member of the American corporation. It is to be noted that this construction of the statute does not preclude the recognition of distributions of profits in accordance with profit-sharing arrangements wherever the distributees may properly be regarded as "members" of the corporation.

The foreign corporation receives an amount which is described as "profits" and is measured by the "net profits" of the American corporation. It does not, however, receive such amount as profits but rather as compensation for the use of a patent—that is, as a royalty. The amount received is none the less a royalty because measured by profits. A royalty may, like compensation for personal services, be on a contingent basis if not unreasonable in other respects. (See Regulations 45, art. 105.) Nor does the fact that the payment is described by the parties as a payment of profits determine its character, if, as here, upon analysis of the entire situation the fact appears to be otherwise. If the payment to the foreign corporation which is described as a portion of the net profits of the American corporation is in fact a royalty, the American corporation has, of course, no true net profits until after the deduction of such royalty. The normal construction of the agreement is that the American corporation is to pay to the foreign corporation as royalty a portion of the amount which would otherwise be the net profits (after the payment of income and profits taxes) of the American corporation.

The answer to the inquiry follows from the conclusion reached as to the nature of the payment, namely, that it is a royalty. Assuming that there is no unreasonable element in the case, the amount payable by the American corporation to the foreign corporation is a proper deduction from the gross income of the American corporation. The amount received by the foreign corporation is income "from sources within the United States" within the meaning of the statute, and the foreign corporation is subject to income and profits taxes thereon as upon income so derived. Apparently the foreign corporation has no office or place of business within the United States and is not, unless by reason of its royalty contract, "engaged in trade or business" therein. The royalty contract as described (inadequately) in the appeal is apparently not such as to bring it within the class of corporations "engaged in trade or business within the United States." Consequently, it is subject to the withholding provisions of section 221 which are extended to corporations by section 237 with respect to enumerated forms of income, to wit, "interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income." The royalty payable to the foreign corporation, including the part thereof which is measured by the net profits of the American corporation, is within this phrase. It is income which is "annual or periodical" and which is "fixed or determinable" in the sense that no part thereof is to be excluded from gross income as a return of capital.

It is held that if the Z Company has no office or place of business within the United States and is not "engaged in trade or business" therein except as described in the inquiry, the 10 per cent tax should be withheld on the entire royalty payable to it by the X Company, including not only the specific royalty but also the contingent or variable royalty; the American corporation should be permitted to take a deduction for the entire royalty (if not unreasonable) and the Z Company should be called upon to pay profits tax upon the net income derived therefrom.

Section 237, Article 601: Withholding in the case of nonresident foreign corporations. 2–19–167. O. D. 112.

Amounts paid to a nonresident alien corporation not having an office or place of business in the United States as compensation for orders secured by it from foreign customers for export booked through such nonresident alien corporation are held not to be income from sources within the United States and not subject to withholding.

Section 237, Article 601: Withholding in the case of nonresident foreign corporations. 11–19–387. O. D. 221.

Where a nonresident alien corporation not having an office or place of business within the United States purchases through an agent in this country bank acceptances at a certain rate of discount and sells such acceptances through that agent or some other agent for a price greater than the price for which purchased, the amount of income received as a result of the transaction represents income from sources within the United States. The amount received from the sale in excess of the purchase price is based on interest as accrued; such interest is therefore held to come within the provisions of fixed or determinable income and is subject to withholding at the rate of 10 per cent when paid to a nonresident alien corporation not having an office or place of business in the United States and 8 per cent when paid to a nonresident alien individual.

Section 237, Article 601: Withholding in the case of nonresident foreign corporations. 27–19–605. O. D. 323.

If a foreign bank establishes a branch in this country no withholding is required.

Section 237, Article 601: Withholding in the case of nonresident foreign corporations.

(See 28–19–616, sec. 240, art. 636.) Withholding in the case of interest credited by a domestic corporation to a foreign subsidiary corporation.

Section 238.—CREDIT FOR TAXES.

Section 238, Article 611: Credit for foreign taxes. 4–19–230. O. D. 147.

Taxes imposed and required by a foreign government to be paid on the basis of dividends declared by corporations under its laws are taxes on the income of the individual stockholders in proportion to the amount of stock held. A United States corporation owning stock in a foreign corporation, taxed on this basis, should report in its return of annual net income for the year in which received its pro rata share of the entire dividend declared, and would be entitled to a credit of the amount of the tax paid by the foreign corporation to the foreign government in its behalf, in accordance with the above provision of law.

On the other hand, taxes imposed by a foreign government on the net income of corporations organized under its laws are not taxes to the individual stockholders, but to the corporation itself, and no part thereof would be a proper credit in the return of annual net income of the recipient United States corporation, which would be taxable on the net amount of the dividend received.

Section 238, Article 611: Credit for foreign taxes.

(See 11–19–388, sec. 240, art. 636.) When domestic corporation controlling foreign corporation may deduct foreign taxes assessed against foreign corporation.

Section 238, Article 611: Credit for foreign taxes.

(See 12–19–407, sec. 222, art. 383.) Conditions of allowance of credit for foreign taxes withheld by foreign corporation.

Section 239.—CORPORATION RETURNS.

2–19–168.
Section 239, Article 621: Corporation returns. S. 972.

Where articles of incorporation are filed and business is transacted in the corporate name a return of income received from such business should be rendered for the corporation, although its organization as a corporation has not been perfected in the manner required by law.

Advice is asked as to how a return of income should be rendered where a corporation fails to perfect its organization and is not legally authorized to engage in business as a corporation. Section 239 of the Revenue Act of 1918 provides that—

Every corporation subject to taxation under this title and every personal-service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. * * *

Article 621 of Regulations No. 45 is as follows:

Every corporation not expressly exempt from tax and every personal-service corporation must make a return of income, regardless of the amount of its net income. * * * A corporation which has received a charter, but has never perfected its organization, and which has transacted no business and had no income from any source, may, upon presentation of the facts to the collector, be relieved from the necessity of making a return so long as it remains in an unorganized condition. In the absence of a proper showing to the collector such a corporation will be required to make a return. * * *

It is stated that A was engaged in business under the name of "A Co.," and that his business became so large that he concluded it would be best to operate as a corporation. In 1918 he filed articles of incorporation for a company to be known as the "A & Co." After incorporation the corporation was never organized by the election of any board of directors; no stock was ever issued, and no property was transferred to the corporation. Certain matters intervened to prevent the consummation of the plan A had in mind of conducting the business under a corporate instead of an individual form, but he continued to carry on his business under the corporate name of "A & Co.," with the word "Incorporated" written thereunder, during the remainder of the year 1918 and the first part of the year 1919. The question is whether he should render a return for 1918 as a corporation or as an individual.

In view of the State statutes the corporation "A & Co." had a corporate existence, and its want of legal organization could not be set up as a defense to any action brought against it. The question whether a corporation has been properly organized or not is a question which can not be raised collaterally.

The business was carried on in such a way as to render the incorporators liable in their corporate capacity. Moreover, the corporation had a de jure existence as to all the world except the State. For the purpose of taxation, therefore, it should not be treated otherwise. In this instance the corporation transacted business and received the income therefrom. Hence it does not come within the provisions of article 621 of Regulations No. 45.

Section 239, Article 621: Corporation returns. 1–19–100.
O. D. 71.

Though the income tax return of a corporation filed in accordance with the Revenue Act of 1917 for a fiscal year ended in 1918 shows a loss, the corporation will nevertheless be required to file a supplemental return in accordance with the Revenue Act of 1918 for such fiscal year.

Section 239, Article 621: Corporation returns. 2–19–169
O. D. 113.

A corporation may submit amended returns for previous years when through wrong accounting practice capital charges have been made to income. An affidavit should be attached, explaining the changes made by such amended returns in the amounts shown on the original return, and explaining why the original returns were not properly prepared and the object of the company in preparing amended returns. Such amended returns will be accepted only when the erroneous charge can be specifically pointed out and the facts proven. The Internal Revenue Bureau reserves the right to penalize for the making of false returns in the past.

Section 239, Article 621: Corporation returns. 4–19–231.
O. D. 148.

The proper officers of a corporation that has been taken over by the Alien Property Custodian should file a return of income and excess profits for the corporation up to the time the property was taken over by the Alien Property Custodian.

The board of directors appointed by the Alien Property Custodian is not required to render a return of net income for the corporation while in control of the Alien Property Custodian.

Section 239, Article 621: Corporation returns.

(See 14–19–438, sec. 234, art. 561.) Corporations may file statement in place of amended return when deductions for contributions were taken on original return filed prior to the issuance of Treasury Decision 2847.

Section 239, Article 622: Returns by receivers. 6–19–280. O. 853.

Income received by assignees appointed by a corporation to liquidate its property and business over a period of years, who have full power of control and management thereof, is taxable. This is true although the business conducted by the trustees in the process of liquidation is not the business which the corporation originally started to conduct. This rule applies to all income received by the trustees, including interest on bank deposits, interest upon deferred payments, and gains upon sales of real property.

Section 239, Article 622: Returns by receivers. 1–19–102. O. D. 73.

A receiver should prepare and file a corporate return of annual net income and excess profits for the entire year, including therein the gross income received by the corporation prior to the time of the receiver's appointment and also the gross income received under the supervision of the receiver.

Section 239, Article 622: Returns by receivers. 2–19–170. O. D. 114.

A receiver liquidating the assets of an insolvent bank is required to file a return for the bank, but in view of the fact that the bank is insolvent and will have no tax to pay (Act of Mar. 1, 1879, sec. 22) the return may contain a statement to that effect in lieu of the data ordinarily required in the return.

Section 22, Act of March 1, 1879, provides that no tax shall be assessed or collected or paid into the Treasury of the United States on account of an insolvent bank which shall diminish the assets thereof necessary for the full payment of all its depositors.

Section 239, Article 622: Returns by receivers.

(See 12–19–406, sec. 233, art. 547.) Return of income received from investments by corporation in liquidation.

Section 239, Article 626: Returns for fractional part of year. 31–19–650. O. D. 352.

If a domestic corporation for any reason files an income-tax return for a period less than a year, the credit provided in section 236 (c) of the Revenue Act of 1918 should be reduced to such proportion of the full credit as the number of months covered by the return bears to 12 months.

Section 240.—CONSOLIDATED RETURNS.

Section 240, Article 632: Consolidated Returns.

(See 6–19–286; sec. 330, art. 933.) Partnership upon becoming a corporation.

Section 240, Article 633: When corporations are affiliated. 16–19–465. T. B. R. 52.

Recommending that the application for permission to file a consolidated return for X and Y as affiliated corporations be denied.

The application for permission to make a consolidated return in the case of the above-named corporations is based upon the fact that the principal stockholders of X are also the principal stockholders of Y. It is the contention of the applicants that the language of the statute, which defines two or more corporations as affiliated "if substantially all of the stock of two or more corporations is owned or controlled by the same interests," means that if a substantially controlling interest in the stock of one corporation is owned by the same stockholders who also own a substantially controlling interest in the stock of the other corporation, a consolidated return is authorized, provided the other conditions of section 240 are satisfied.

The taxpayer has presented argument to show that the last sentence of article 633 of Regulations 45 does not correctly interpret the law, and that the bureau has narrowed the meaning of the sentence which provides that "two or more domestic corporations shall be deemed to be affiliated if substantially all of the stock of two or more corporations is owned or controlled by the same interests." The board agrees with the representative of the corporation that a broad and liberal interpretation should be given to the word "substantially" in the last sentence of article 633 of Regulations 45, but it does not appear that either under the statute or the regulations can a case in which 25 per cent of the stock of Y is owned by individuals who held no stock whatever of X and more than 6 per cent of the stock of X is held by individuals who hold no stock of Y be considered a case in which substantially all of the stock of two or more corporations is owned or controlled by the same interests.

In view of the above statements of facts there does not appear to be such ownership or control of stock in the two corporations as would warrant the filing of a consolidated return.

Section 240, Article 633: When corporations are affiliated. 7–19–304. T. B. M. 32.

Recommendation in the case of the application for permission to file a consolidated return for the X company and the Y company, the two sole stockholders of which are the same individuals.

The application for permission to file a consolidated return in the case of the X Company and the Y Company is based upon the fact that each corporation has the same stockholders, two individuals owning all of the stock of each corporation. The claimant points out that article 633 of Regulations 45 provides that an owning or controlling of 95 per cent or more of the outstanding voting capital stock at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. The applicant fails to note the requirement that when the stock of two or more corporations is owned by two or more individuals the percentage of stock held by each individual should be substantially the same in each of the affiliated corporations. In one of the corporations one stockholder owns 90 per cent of the stock, while the other owns but 10 per cent. In the other corporation the same stockholder who owns 90 per cent in the first-mentioned corporation owned on January 1, 50 per cent of the stock of the second corporation, which was increased later to 75 per cent. The minority stockholder in the first corporation held the minority interest in the second corporation, which was 50 per cent and 25 per cent for the same periods. It is very apparent, therefore, that these two stockholders were simply associated in two separate enterprises which the record fails to show were affiliated in any manner whatever.

On the facts presented it would appear that the Bureau would be unable to compel either of these corporations to pay a tax based upon a consolidated return if the corporations failed to pay such tax voluntarily, because of the disparity of the holdings of the stockholders in the two corporations. If the collateral interests are such as to make the companies willing to make a consolidated return, they nevertheless should not be permitted to do that which they could not be required to do.

Section 240, Article 636: Domestic corporation affiliated with foreign corporation. 11–19–388. T. B. R. 36.
(Also Section 238, Article 611.)

REVENUE ACT OF 1918.

Credit for foreign taxes.—A domestic corporation which owns a majority of the voting stock of a foreign corporation is not entitled to credit under Section 240 (c) of the Revenue Act of 1918 for income, war profits and excess profits taxes paid by such foreign corporations to any foreign country or possession of the United States, which are not *actually paid* within the taxable year of the domestic corporation for which the credit is claimed.

In the preparation of forms for claiming credits for foreign taxes a question has arisen as to the extent of credits to be allowed to domestic corporations owning stock in foreign corporations for taxes paid by such foreign corporations to foreign countries and to possessions of the United States. Section 238 (a) provides in part as follows:

That in the case of a domestic corporation the total taxes imposed for the taxable year by this title and by Title III shall be credited with the amount of any income, war profits and excess profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein; or to any possession of the United States;

and recognizes that under certain circumstances the authorized credits include "accrued" taxes. Section 200 contains the following definition:

The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 213.

Section 240(c) is as follows:

For the purposes of section 238, a domestic corporation which owns a majority of the voting stock of a foreign corporation shall be deemed to have paid the same proportion of any income, war profits and excess profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources within the United States, which the amount of any dividends (not deductible under section 234) received by such domestic corporation from such foreign corporation during the taxable years bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid: *Provided,* That in no such case shall the amount of the credit for such taxes exceed the amount of such dividends (not deductible under section 234) received by such domestic corporation during the taxable year.

The question is whether under these statutory provisions a domestic corporation is entitled to credit for taxes paid by a subsidiary foreign corporation to foreign countries or to possessions of the United States in the taxable year of such domestic corporation within which such taxes were paid, or in the taxable year of the domestic corporation within which liability for such taxes accrued against the foreign corporation.

Section 230 read in connection with section 200 provides for crediting foreign taxes paid by or accrued against a domestic corporation, but such domestic corporation is not, under these sections alone, entitled to credit for the taxes of a foreign subsidiary. Section 240 (c), however, provides that for the purposes of this credit certain taxes of a foreign subsidiary shall be "deemed to have been paid" (which, under section 200, means accrued in the case of a corporation reporting on the basis of accruals) by the domestic parent corporation. This provision for deeming taxes of a foreign subsidiary corporation to have been paid by or accrued against a domestic corporation applies only to taxes paid by such foreign subsidiary, and taxes accrued against such foreign subsidiary are expressly excluded from its application. Clearly, therefore, taxes which have accrued against a foreign subsidiary, but have not been actually paid by it, are not included within the taxes for which the domestic parent corporation is entitled to be credited under section 238.

It has been suggested that, though a domestic corporation is not entitled to credit for taxes which have accrued against a foreign subsidiary, but which have not been actually paid by it, when the accrued taxes have actually been paid by the foreign subsidiary the domestic corporation is entitled to credit therefor in the year in which such foreign taxes accrued. This construction is not warranted by the language. Section 238 authorizes a credit for taxes paid (or accrued) "during the taxable year." Section 240(c) provides that for the purposes of that section the domestic corporation shall be deemed to have paid (or accrued) "taxes paid (but not including taxes accrued)" by the foreign corporation "during the taxable year." The "taxable year" referred to in these two sections is the same year and the necessary conclusion is that the credit to which the domestic corporation is entitled is for taxes actually paid by the foreign corporation "during the taxable year" for which the credit is claimed. A contrary conclusion can be reached only by reading the word "during" as equivalent to "for" which is wholly unwarranted. There is nothing in the context or in the history of the legislation to indicate that Congress used the language in question in other than its ordinary sense.

It is to be noted that if taxes paid by a foreign subsidiary corporation are to be credited to the domestic parent corporation for the year in which such taxes accrued against the foreign subsidiary no credit can be allowed for taxes paid by such foreign subsidiary in 1918 and subsequent years which accrued prior to 1918, for the credit in question is by the terms of section 238 allowed only against taxes imposed by the Revenue Act of 1918. It is known, however, that many foreign taxes which accrued prior to 1918 remain unpaid. It is believed that Congress intended to allow credits for such taxes paid in 1918 and in subsequent years, although they accrued prior to 1918.

In the opinion of the Advisory Tax Board, therefore, a domestic corporation which owns a majority of the voting stock of a foreign corporation is not entitled to credit under section 240(c) of the Revenue Act of 1918 for income, war profits, and excess profits taxes paid by such foreign corporation to any foreign country or possessions of the United States, which are not *actually paid* within the taxable year of the domestic corporation for which the credit is claimed.

Section 240, Article 636: Domestic corporation affiliated with foreign corporation. 28–19–616. O. D. 330.
(Also Section 237, Article 601.)

A domestic corporation owning a majority of the stock of foreign corporations should include in its income tax return any amounts of interest debited to its foreign subsidiaries, but it may claim as a deduction any amount of interest credited to such subsidiaries. The domestic corporation should also withhold and pay to the Government a tax equal to 10 per cent of the amount of the interest credited to its foreign subsidiaries.

Part IV.—Administrative Provisions.

Section 250.—PAYMENT OF TAXES.

Section 250, Article 1001: Time for payment of tax. 1–19–15. S. 920.

Treasury Decision 2797, prescribing the time when additional amounts of tax owing by a taxpayer whose return for the taxable year 1918 was on a fiscal-year basis should be paid, is valid and not in conflict with the provisions of the Revenue Act of 1918.

Section 205(a) of Revenue Act of 1918 provides in the second paragraph:

Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by Title I of the Revenue Act of 1916, as amended by the Revenue Act of 1917 and by Title I of the Revenue Act of 1917, shall be credited toward the payment of the tax imposed for such fiscal year by this Act, and if the amount so paid exceeds the amount of such tax imposed by this Act, or in the case of a personal service corporation, the amount specified in clause (1), the excess shall be credited or refunded in accordance with the provisions of section 252.

In Solicitor's Memorandum No. 886 it was held, following Treasury Decision 2797, "that the payment in installments applies only to the additional tax based on the return previously filed and growing out of the increase of rates." The same conclusion was reached in Solicitor's Memorandum No. 857.

The Revenue Act of 1918 was retroactive as to the tax to be assessed for the year 1918, but the Act was not retroactive as to the administrative features contained in it. This is illustrated, especially, in the case of withholdings and the methods of paying. Withholding is only required, and, in the nature of things, can only be performed at the time payment is made. After the parting with the money or other thing of value it can no longer be withheld; the tax could be *paid*, but not *withheld*. (Law Opinion 762.) The same reasoning is applicable to the instant case. The amount of tax paid under the Revenue Act of 1917 before the effective date of the Revenue Act of 1918 will merely be *held* until the whole tax is paid. The further amounts becoming due on account of the increase in rates will be treated as the part of the tax due under existing rulings. The amount paid under the Revenue Act of 1917 was not erroneously paid. It was paid in accordance with the provisions of the Revenue Act of 1917 at a time when that Act was to be given full force and effect. Thus, it is proper that the amounts paid under the Revenue Act of 1917 be held until the whole tax is paid and the further amount growing out of the increased rates be payable according to rulings existing subsequent to February 24, 1919. The amount paid on account of the Revenue Act of 1917 is, in this manner, "credited toward the payment of the tax" growing out of the increased rate of the Revenue Act of 1918.

A large measure of authority and discretion in the matter of prescribing rules and regulations for the assessment and collection of the tax has been confided to the administrative officers of the Government. And "there is a marked increasing tendency to leave more and more of what may be called the detail of legislation to such officers and commissions, the legislature settling the general policy and outline of the laws on a given subject and confiding to administrative agencies the work of erecting the machinery necessary for their practical operation and their application in particular cases." (Black, Const. Law (3d ed.), pp. 96, 97, and cases therein cited, including Union Bridge Co. *v.* U. S., 204 U. S., 364, 385; Field *v.* Clark, 143 U. S., 649, 681, 693; Coopersville, etc., Co. *v.* Lemon, 163 Fed., 145.)

Treasury Decision 2797 merely prescribes the method of payment of the further amount of tax growing out of the increased rate of the Revenue Act of 1918 and is within the administrative authority and discretion granted for purposes of the practical operation of the Revenue Act of 1918.

Section 250, Article 1001: Time for payment of tax.

(See 26-19-599; sec. 328, art. 914.) Payment of tax in special cases when tax in first instance not computed in accordance with article 912.

Section 250, Article 1002: Payment of tax when no proper return. 23-19-551. O. 926.
(Also Section 214, Article 101.)
(Also Section 234, Article 561.)
(Also Section 236, Article 591.)

ADMINISTRATIVE: SECTION 3176, R. S., AS AMENDED—INCOME TAX: ACT OF SEPTEMBER 8, 1916, AS AMENDED BY THE ACT OF OCTOBER 3, 1917, AND ACT OF FEBRUARY 24, 1919.

Addition to tax for delinquency or fraud.—(1) The addition to tax authorized to be assessed by section 3176, Revised Statutes, as amended, on delinquent or false and fraudulent returns is to be considered a penalty and not a tax except for purposes of collection.

(2) Such an addition to tax made on excess profits tax returns is not an allowable credit in arriving at the net income subject to normal income tax.

(3) The payment of such an addition to tax is not to be disallowed as a deduction from gross income in obtaining net income on the ground that it is a part of the income or profits tax within the provisions of law forbidding the deduction from gross income of those taxes.

(4) The payment of an addition to tax for delinquency in filing a return may be deducted from gross income as a business expense when such an addition to tax is an incident to carrying on a business or trade. The payment of an addition to tax upon a false or fraudulent return may not ordinarily be deducted from gross income as a business expense and may never be deducted in the case of an individual who himself was guilty of making a fraudulent return.

Opinion is requested upon the question whether the addition to the tax authorized by section 3176, Revised Statutes, as amended, shall be considered for income tax purposes as a tax or as a penalty.

Section 3176, Revised Statutes, as amended by the Act of September 8, 1916, provides:

In case of any failure to make and file a return or list within the time prescribed by law or by the collector, the Commissioner of Internal Revenue shall add to the tax fifty per centum of its amount * * *. In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax one hundred per centum of its amount. The amount so added to any tax shall be collected at the same time and in the same manner as part of the tax unless the tax has been paid before the discovery of the negligence, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax.

Section 3176, Revised Statutes, was further amended by section 1317 of the Revenue Act of 1918, the material change, so far as the present opinion is concerned, being that the penalties provided for by section 3176, Revised Statutes, as amended by the Revenue Act of 1916 were reduced to 25 per cent and 50 per cent, respectively.

Section 29 of the Act of September 8, 1916, added by section 1211 of the Act of October 3, 1917, provides:

That in assessing income tax the net income embraced in the return shall also be credited with the amount of any excess profits tax imposed by act of Congress and assesed for the same calendar or fiscal year upon the taxpayer, and, in the case of a member of a partnership, with his proportionate share of such excess profits tax imposed upon the partnership.

Section 1207 of the Act of October 3, 1917, amended the Act of September 8, 1916, by providing that income and excess profits taxes shall not be legal deductions from gross income in the returns of individuals, corporations, etc. Similar provisions are contained in the Act of February 24, 1919 (sec. 214 (a) (3); sec. 234 (a) (3)).

The 50 per cent addition to tax, imposed by section 3176, has been held by the Attorney General to be a penalty and not a tax. (17 Op. Atty. Gen., 435.) In Law Opinion 922 it was held that interest at the rate of 1 per cent per month, prescribed by section 3184, Revised Statutes, and certain sections of the Revenue Act of 1918, constitutes no part of the tax, although it is to be collected in the same manner as the tax.

From an inspection of section 3176, Revised Statutes, it appears to be clear that the amount to be added to the tax and designated as "part of the tax" is to constitute a part of the tax for the purpose of collection only. There is no necessary implication that the addition to the tax is to be considered for all purposes the same as the tax. It is not imposed by the same provisions of law as the tax is imposed. It is imposed upon the taxpayer by reason of delinquency in the filing of a return or by reason of fraud in the preparation of the return.

Since the additions to tax, authorized by section 3176, Revised Statutes, as amended, are to be considered the same as the tax only for the purpose of collection, it necessarily follows that they should not be considered as credits under section 29 of the Act of September 8, 1916, added by section 1211 of the Act of October 3, 1917. For the same reason the provisions of law cited above to the effect that income and excess profits taxes may not be deducted from the gross income do not apply.

The question whether penalties of the character described are legal deductions from gross income is one which must be determined on the facts in a given case. These penalties may be an incident to the conduct of a business. Where by reason of the negligence of some clerk or officer of a corporation a penalty is incurred and paid, the penalty is an ordinary and necessary business expense and may legally be deducted from gross income. The same may also be true of the penalty imposed for delinquency in the filing of an individual return. Additions to tax for fraudulent returns do not constitute necessary business expenses. An individual who himself is guilty of making a fraudulent return should not be allowed to deduct the penalty which he is required to pay for making such a return.

In conclusion it is held that (1) the addition to tax authorized to be assessed by section 3176, Revised Statutes, as amended, on delinquent or false and fraudulent returns is to be considered a penalty and not a tax except for purposes of collection; (2) such an addition to tax made on excess profits tax returns is not an allowable credit in arriving at the net income subject to normal income tax; (3) the payment of such an addition to tax is not to be disallowed as a deduction from gross income in obtaining net income on the ground that it is a part of the income or profits tax within the provisions of law forbidding the deduction from gross income of those taxes; and (4) the payment of an addition to tax for delinquency in filing a return may be deducted from gross income as a business expense when such an addition to tax is an incident to carrying on a business or trade. The payment of an addition to tax upon a false or fraudulent return may not ordinarily be deducted from gross income as a business expense and may never be deducted in the case of an individual who himself was guilty of making a fraudulent return.

Section 250, Article 1002: Payment of tax when no proper return. 20–19–516. S. 1156.

INCOME TAX: REVENUE ACT OF 1918, SECTION 1317.

Returns.—Discussion of how same may be procured and tax collected from a taxpayer who has removed from the United States.

Advice has been asked as to the procedure to be followed to procure a return of income for the year 1918 in the case of an individual who, after disposing of his holdings in the United States, left the country and is now residing in British Columbia.

Section 3176 of the Revised Statutes as amended by section 1317 of the Revenue Act of 1918 provides in part:

> If any person, * * * fails to make and file a return or list at the time prescribed by law * * * the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes.
>
> If the failure to file a return or list is due to sickness or absence, the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.
>
> The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section. * * *

It appears that A filed a return of his income for the year 1917 and paid the tax shown to be due thereon. Prior to the time when a return should have been filed for 1918, A sold all his holdings in the United States and moved to British Columbia. Since removing from the United States A has not filed a return for 1918, although he had income from sources within the United States. It is not known whether A is an American citizen. The question now arises as to the procedure to be followed in procuring a return for 1918 from A.

If A is a citizen of the United States he is liable to income tax upon his income from all sources. (Law Opinion 298.) If, on the other hand, he is a nonresident alien he is liable to an income tax upon his income received from sources within the United States. (Regulations 45, art. 91.)

An effort should be made through the American consul in British Columbia to have A file a return for the year 1918 and pay any taxes shown to be due thereon. If A refuses to make a return, then the Commissioner should make a return for him, from such information as he can obtain, and make an assessment on the basis of the return so made, in accordance with the provisions of section 1317, supra. If upon investigation it is found that the taxpayer has no real or personal property within the United States on which a levy might be made, but that a judgment for the amount of tax due for 1918 could be satisfied out of the property held by the taxpayer in

British Columbia, the courts of that country should be availed of for the purpose of collecting such taxes as are due for that year. The right of the United States to avail itself of this privilege is clearly stated in The Sapphire (78 U. S., 164). In that case the court said at page 167: "The Constitution expressly extends the judicial power to controversies between a State, or citizen thereof, and foreign States, citizens, or subjects, without reference to the subject matter of the controversy. Our own Government has largely availed itself of the like privilege to bring suits in English courts in cases growing out of our late Civil War. Twelve or more of such suits are enumerated in the brief of the appellees, brought within the last five years in the English law, chancery, and admiralty courts." See also Moore's International Law Digest (vol. 2, p. 85); Columbia *v.* Cauca Co. (190 U. S., 524); King of Spain *v.* Oliver (2 Wash. C. C., 429). Compare Wisconsin *v.* Pelican Insurance Co. (127 U. S., 265). The bringing of suit for collection of tax shown to be due for 1918 could be accomplished through the employment of counsel in British Columbia for that purpose.

Section 250, Article 1003: Interest on tax. 13–19–426.
O. 884.

INTEREST AT THE RATE OF 1 PER CENTUM PER MONTH.

(1) Where interest is collectible at the rate of 1 per centum per month from the due date interest must be collected for the fractional part of a month where the tax is not paid within 10 days from notice and demand for payment.

(2) Under sections 502, 504, 629, 903, and 905 interest is collectible at the rate of *1 per centum for each full month* and fractional parts of a month must be disregarded.

(3) Interest is collectible from the date the tax becomes due.

Opinion is requested upon the following questions relative to Forms 17 and 21:

(1) Whether interest payable at the rate of 1 per centum for each full month may be collected for the fractional part of a month.

(2) From what date the interest should be computed.

Section 250 (e) of the Revenue Act of 1918 provides:

If any tax remains unpaid after the date when it is due and for 10 days after notice and demand by the collector, then * * * there shall be added as part of the tax the sum of 5 per cent on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due * * *.

With respect to the time when taxes are due, section 250 (a) provides as follows:

* * * The first installment shall be paid at the time fixed by law for filing the return, and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. * * * If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

Section 250 (b) provides:

If the amount already paid is less than that which should have been paid, the difference shall, to the extent not covered by any credits then due to the taxpayer under section 252, be paid upon notice and demand by the collector.

In such case if the return is made in good faith and the understatement of the amount in the return is not due to any fault of the taxpayer, there shall be no penalty because of such understatement. If the understatement is due to negligence on the part of the taxpayer, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency, plus interest at the rate of 1 per centum per month on the amount of the deficiency of each installment from the time the installment was due.

Section 502 of the Act provides:

The tax shall, without assessment by the Commissioner or notice from the collector, be due and payable to the collector at the time so fixed for filing the return. If the tax is not paid when due, there shall be added as part of the tax a penalty of 5 per centum, together with interest at the rate of 1 per centum for each full month, from the time when the tax became due.

(1) Heretofore this office has held repeatedly that no interest for a fraction of a month shall be demanded (Reg. 1, revised 1907, p. 111; Reg. 1, revised 1917, p. 150; Reg. 2, revised July 5, 1916, p. 50). The former ruling was apparently based upon the language of sections 3184 and 3185, Revised Statutes. Section 3184 provides for the collection of interest upon delinquent payments of tax "at the rate of 1 per centum a month." Section 3185 provides for the collection of "interest at the rate of 1 per centum per month, upon such tax from the time the same became due; but no interest for a fraction of a month shall be demanded.' A reference to decisions of the courts in internal revenue cases prior to 1890 would indicate that it had been the practice of this office from the beginning to disregard parts of a month in computing interest at the rate of 1 per centum per month under section 3184.

In article 1003 of Regulations 45 the provision of the law that interest shall be payable at the rate of 1 per centum per month has been construed as the equivalent of interest payable at the rate of 12 per centum per annum. It is believed that the ruling is correct. Accordingly it is held that interest at the rate of 1 per centum per month upon delinquent payments of income and excess profits tax is collectible for a fractional part of a month.

(2) Section 502 of the Revenue Act of 1918 provides for the collection of interest upon delinquent payments of taxes imposed under section 500 at the rate of 1 per centum for each full month. The words "full month" imply that interest is not to be collected for the fractional part of a month. Section 3185, Revised Statutes, relating to monthly returns, provides, as above indicated, that "no interest for a fraction of a month shall be demanded." It is to be presumed that the provision of section 502 has specific reference to section 3185, Revised Statutes. Returns required under sections 504, 629, 903, and 905 of the Revenue Act of 1918 are subject to the provisions of section 502. It is accordingly held that with reference to returns required under these sections fractional parts of a month shall be disregarded in computing interest at the rate of 1 per centum per month.

(3) According to section 250 (a), in any case in which the time for payment of any installment is at the request of the taxpayer postponed, there is to be added as part of the installment interest thereon at the rate of one-half of 1 per centum per month from the time it would have been due if no extension had been granted until paid. The computation of the interest in such case is of necessity from the date the installment became due. It is also provided in the same

subdivision that if any installment is not paid when due the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector. In such case the due date is the date of the notice and demand by the collector, and interest must be computed from that date.

In subdivision (b) of section 250 it is stated that if the understatement is due to negligence on the part of the taxpayer, but without intent to defraud, there shall be added as a part of the tax 5 per centum of the total amount of the deficiency plus interest at the rate of 1 per centum per month on the amount of the deficiency of each installment from the time the installment was due. In such case interest must be computed from the date the installment was due.

In subdivision (e) of section 250 it is provided that if any tax remains unpaid after the date when it is due and for 10 days after notice and demand by the collector, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid plus interest at the rate of 1 per centum per month upon such amount from the time it became due, but that as to any such amount which is the subject of a bona fide claim for abatement, interest from the time the amount was due until the claim is decided shall be at the rate of one-half of 1 per centum per month. In such case the interest collectible must be computed from the due date and not from the tenth day after the date of the notice and demand for payment.

The rules above laid down are contrary to that laid down in article 263 of Regulations No. 33 (revised), where it is stated that where an abatement claim is filed after a notice and demand for payment has been made by the collector "interest at 1 per cent per month continues to run and should be collected with the tax at the time of payment for the full number of calendar months which intervene between the date of the expiration of the first 10-days' notice and the date of the payment of the tax, notwithstanding the fact that a claim for abatement has been filed." The same language is also contained in Regulations 14, page 14. Subdivision (e) of section 250 makes this regulation ineffective as applied to claims for the abatement of income and excess profits taxes assessed, and it is accordingly recommended that a uniform regulation be established to the effect that interest shall in all cases be computed from the due date, and that where a tax is made payable by the issuance of a notice and demand for payment, interest be computed from the date of such notice and demand for payment.

It is therefore held as follows:

(1) Where interest is collectible at the rate of 1 per centum per month from the due date interest must be collected for the fractional part of a month where the tax is not paid within 10 days from notice and demand for payment.

(2) Under sections 502, 504, 629, 903, and 905 interest is collectible at the rate of 1 per centum for each full month, and fractional parts of a month must be disregarded.

(3) Interest is collectible from the date the tax becomes due.

Section 250, Article 1003: Interest on tax. **1–19–106.**
O. D. 74.

Any deficiency in the first installment of tax as shown by the completed return must be paid together with interest thereon from March

15, at the rate of one-half of 1 per cent per month at the time of filing such return, and a further sum sufficient with any amounts already paid, exclusive of interest, to equal one-half of the tax shown by the completed return must be paid on or before June 15.

Section 250, Article 1003: Interest on tax. 4–19–323.
O. D. 149.

When it is found upon filing a complete return, that the first installment of tax was underestimated at the time of filing a tentative return, interest on the amount by which the tax was underestimated must be collected irrespective of amount.

Section 250, Article 1003: Interest on tax. 13–19–427.
O. D. 247.

In the case of rejected claims for abatement filed for taxes due for years prior to 1918, interest may be collected at the rate of 1 per cent per month; for 1918 and subsequent years at the rate of one-half of 1 per cent per month; when based on inventory losses the interest should be collected at the rate of 1 per cent per month.

Section 250, Article 1003: Interest on tax. 26–19–595.
(Also Section 214, Article 101.) O. D. 319.
(Also Section 234, Article 561.)

Interest paid or accrued under the provisions of section 250 of the Revenue Act of 1918 is deductible under the provisions of section 214 (a) or section 234 (a) (2) in computing net income. The word "interest," referred to in section 250 (a), is synonymous with that in section 3184, Revised Statutes, and may be treated as a deductible item of expense.

Section 250, Article 1004: Penalty for failure to file return. 3–19–204.
O. 818.

Where the attendant and surrounding circumstances have a tendency to cast doubt and suspicion upon a taxpayer, a plea of mere ignorance is not sufficient to constitute a reasonable cause for failure to make and file a return within time prescribed by law for the purpose of being relieved of the penalty.

Section 250, Article 1004: Penalty for failure to file return. 7–19–306.
T. B. R. 31.

Penalties for delinquencies in filing supplemental tax returns for fiscal years ending in 1918 should be imposed upon corporations as for delinquencies in filing tax returns for the calendar year 1918, subject to such modifications in cases of compromises as may seem to be warranted by the circumstances.

The opinion of the Advisory Tax Board is requested as to whether the additional taxes shall be assessed and specific penalties asserted in the case of corporate taxpayers which, prior to the passage of the Revenue Act of 1918, filed tax returns for fiscal years ending during that year, but are delinquent in filing supplemental returns required by the Revenue Act of 1918.

The general extension of the time to June 15, 1919, for completing corporate returns is understood to apply to corporations making returns on the basis of fiscal years ending in 1918, as well as to corporations making returns on the basis of the calendar year 1918. It is suggested, doubtless because such fiscal year corporations have already filed returns for the fiscal year 1918 in accordance with the provisions of prior laws, that corporations which are delinquent in filing supplemental returns for such fiscal years ending in 1918 should not be subject to additional taxes or penalties by reason of such delinquencies.

The filing of supplemental returns by corporations having fiscal years ending in 1918 is essential to the proper administration of the Revenue Act of 1918, and all reasonable measures should be taken to compel such filing. A corporation which has duly filed its return for such a fiscal year, as required by previous laws, may be entitled to some consideration on this account and may have some reason for the belief that it has performed its full duty. On the other hand, such a corporation is bound to know at its peril of its duty to file such supplemental return. The extension to June 15, 1919, of the time for filing gives ample opportunity to a corporation to prepare its supplemental return, especially since many of the items included therein will be identical with items included in the return previously filed. The filing of a return for a fiscal year ending in 1918, as required by previous laws, is not therefore in and of itself a "reasonable cause" within the meaning of the statute (see Revised Statutes, section 3176, as amended by section 1317 of the Revenue Act of 1918) for failure to file the supplemental return. It seems, therefore, that from the standpoint of the Government it is necessary as well as legal, and from the standpoint of the taxpayer it is not unfair, to assess additional taxes and assert penalties against corporate taxpayers which are delinquent with respect to such supplemental returns. In any compromises of such penalties, however, the fact that the delinquency was with respect to a supplemental return and that the original return was filed in accordance with law, may properly be taken into account.

It is recommended, therefore, that penalties for delinquencies in filing supplemental returns for fiscal years ending in 1918 should be imposed upon corporations as for delinquencies in filing tax returns for the calendar year 1918, subject to such modifications in cases of compromises as may seem to be warranted by the circumstances.

Section 250, Article 1005: Penalty for Understated Return. 1–19–105. S. 926.

A taxpayer who filed a return of income which did not include profit on the sale of certain corporate stock and in reply to an inquiry by an examining officer stated that he had not made any money on outside investments during the year, but in reply to a direct inquiry in regard to the sale of the stock, based on confidential information, admitted the sale, but made no explanation of his failure to include the profit on the sale in his return for the taxable year, is held to have filed a false and fraudulent return for the purpose of evading taxation and the 100 per cent additional tax should be assessed. (1913 Act.)

Section 250, Article 1006: Penalty for nonpayment of tax. 18–19–486. O. D. 270.

The charge of $5 is to be added as a part of the tax when a warrant of distraint is served, irrespective of the fact that the delinquent may be the estate of an insane, deceased, or insolvent person.

Section 250, Article 1006: Penalty for nonpayment of tax. 24–19–575. O. D. 304.

The penalty of $5 added as a part of the tax where a warrant of distraint is served is applicable only to income, war profits, and excess profits taxes.

Section 250, Article 1006: Penalty for nonpayment of tax. 25–19–588. O. D. 313.

In cases where delinquent returns are filed and the total tax is paid at the time of filing, the penalty of 5 per cent and interest at the rate of 1 per cent per month do not attach.

Section 250, Article 1007: Notice and demand of payment. 12–19–408. O. D. 233.

Under section 250 (a), if any installment is not paid when due the whole tax unpaid shall become due and payable upon notice and demand by the collector. It will be seen, therefore, that individuals who filed their returns without making payment of at least one-fourth of the amount should receive a notice on Form 21, covering the correct amount of the first installment, which carries interest from the date on which return should have been filed up to the date on which payment is made.

They should also receive Form 17, notice and demand for the amount covered by the second, third, and fourth installments, and an additional Form 21, covering such amount, if the total is not paid within 10 days. Such taxpayers will not be entitled to the installment privileges and payment should be demanded in full, as indicated above.

Section 250, Article 1008: Collection of tax by suit. 4–19–235. O–833.

> The five-year limitation on assessment and suit contained in section 250 (d) applies only to taxes due under the Revenue Act of 1918.
>
> Section 252 does not operate so as to take away the rights which a taxpayer has under section 3228, Revised Statutes, to file a claim for refund within two years after the time the cause of action accrued.
>
> The five-year limitation in section 252 does not apply to claims for abatement.

Advice is requested concerning the proper construction to be placed on sections 250 (d) and 252 of the Revenue Act of 1918, and section 3228 of the Revised Statutes.

Section 250 (d) provides that—

> Except in the case of false or fraudulent returns with intent to evade the tax, the amount of tax due under any return shall be determined and assessed by the Commissioner within five years after the return was due or was made, and no suit or proceeding for the collection of any tax shall be begun after the expiration of five years after the date when the return was due or was made. In the case of such false or fraudulent returns, the amount of tax due may be determined at any time after the return is filed, and the tax may be collected at any time after it becomes due.

Section 252 provides as follows:

> That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce the tariff duties and to provide revenue for the Government, and for other purposes," the Revenue Act of 1916, as amended, or the Revenue Act of 1917, it appears that an amount of income, war profits, or excess profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war profits, or excess profits taxes, or installment thereof then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided*, That no such credit or refund shall be allowed or made after five years from the date when the return was made, unless before the expiration of such five years a claim therefor is filed by the taxpayer.

Section 3228 provides that—

> All claims for the refunding of any internal tax alleged to have been erroneously or illegally assessed or collected, or of any penalty alleged to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, must be presented to the Commissioner of Internal Revenue within two years next after the cause of action accrued. *Provided*, That claims which accrued prior to June 6, 1872, may be presented to the Commissioner at any time within one year from said date. But nothing in this section shall be construed to revive any right of action which was already barred by any statute on that date.

The following questions are asked with reference to the sections above quoted:

1. Do the limitation provisions of section 250 (d) extend beyond the taxes imposed under the Revenue Act of 1918 and set up a limitation against the Government in suits brought for the collection of taxes due under previous income tax acts?

This question must be answered in the negative. Ordinarily a statute of limitations does not apply to suits brought by the Government for taxes due and unpaid. Where this privilege is waived by statute, the limitation which the Government sets up against itself should not be extended to suits for taxes other than those imposed by the law in which the limitation is found, unless it has been specifically provided that the limitation is to apply to suits for taxes due under former laws. Moreover, the intention of the legislature must govern the construction of a tax law. If the intention of the legislature is not clear in one section, resort may be had to other sections of the law to determine the real intention. (See Cooley on Taxation, vol. 1, pp. 450, 451.) Section 252 makes special reference to taxes paid under previous income tax acts and provides that no refund or credit for taxes paid shall be allowed or made after five years from the date when the return was due, unless the claim was made before the expiration of five years. If Congress intended that section 250 (d) should be construed so as to apply to suits for taxes due under income tax laws other than the Revenue Act of 1918, it is only reasonable to suppose that a specific provision similar to that found in section 252 would have been inserted therein.

2. Does section 3228 of the Revised Statutes permit the filing of claims for refund of taxes paid under any of the Acts specified in section 252 of the Revenue Act of 1918 after five years from the date the return was due?

The view has been expressed that section 252 does not repeal section 3228, but merely supplements the latter, and whatever rights a taxpayer may have under section 3228 are preserved and further extended by section 252. In other words, it is said that a claim for refund may be filed under section 252 within five years after the due date of the return for the year involved, and that a claim for refund may also be filed within two years after payment of the tax, or the time when the cause of action accrued, as provided in section 3228. This construction is advanced for the reason that taxpayers would otherwise have no relief by way of filing claims for refund with reference to assessments under the Revenue Act of 1918, made just prior to the date when the five-year limitation expired.

No suit may be brought for the collection of any taxes alleged to have been erroneously collected until an appeal has been made to the Commissioner of Internal Revenue and a decision of the Commissioner has been had therein. (R. S. 3226.) Consequently if the taxpayer is required to pay the taxes assessed against him at a time when the period within which a claim for refund may be filed has expired he could never maintain a suit to recover the taxes paid. Nor could the collection of the tax be enjoined. It is therefore held that section 252 of the Revenue Act of 1918 was not intended to take away the right given a taxpayer under section 3228 of the Revised Statutes to make a claim for refund within two years after the cause of action accrued or the date of the payment of the tax under protest. As another has said, "perhaps the mere textual construction is in favor of the other view" but a contrary construction would not be harmonious with the spirit of the present law, which is designed to grant relief in cases when Revised Statutes 3228 works injustice.

3. Granting that section 250 (d) does not bar the collection of taxes due under past income tax Acts, and that claims for refund of taxes paid under such Acts are barred by section 252 after the expiration of five years from the date when the return was due, unless still permissible under Revised Statutes, 3228, does section 252 establish a bar for abatement claims?

Section 252 does not prohibit the filing of claims for abatement. Such claims may be filed at any time after assessments are made and before the taxes assessed are paid or collected.

It is held:

1. The 5-year limitation on assessment and suit contained in section 250 (d) applies only to taxes due under the Revenue Act of 1918.

2. Section 252 does not operate so as to take away the rights which a taxpayer has under section 3228, Revised Statutes, to file a claim for refund within two years after the time the cause of action accrued.

3. The 5-year limitation in section 252 does not apply to claims for abatement.

Section 250, Article 1008: Collection of tax by suit. 1–19–107.
O. D. 75.

If a corporation in process of dissolution does not reserve sufficient funds to pay any income tax assessed against it, the liability for the amount of tax remaining unpaid attaches to the individual stockholders, and if necessary, legal proceedings may be instituted against them for collection of the tax.

Section 250, Article 1008: Collection of tax by suit. (Also Section 1400.) 12–19–409. O. D. 234.

Where it is discovered that further taxes for 1913 and other years prior to 1918 are due from individuals and the discovery is not made until after three years from the date the returns for such years were due, amended returns or waivers should be secured, as heretofore, in order that the further taxes due may be assessed and collected without the necessity of instituting suit against the taxpayers.

Section 250, Article 1013: Declaration of termination of taxable period. 8–19–205. O. D. 131.

An alien who desires to depart from the United States is required to submit to the proper officials a certificate signed either by the collector of internal revenue for the district in which he last resided or for the district in which the port of embarkation is located, stating that the collector has satisfied himself that the alien has complied with all tax obligations with respect to income accruing up to the end of the month just preceding the date of the issuance of the certificate.

Section 250, Article 1013: Declaration of termination of taxable period. 18–19–487. O. D. 271.

The instructions issued in IT–MIM 2195 (I. T. R. 13–19–429; sec. 250, art. 1013) and other instructions issued with respect to departing aliens are not applicable to representatives of foreign countries bearing diplomatic passports.

Section 250, Article 1013: Declaration of termination of taxable period. 27–19–606. O. D. 324.

Certificates of compliance with income tax obligations may be procured either from the office of a collector of internal revenue or from the branch office of the collector within the same collection district. The deputy collector or revenue agent acting for the collector will issue the certificates.

Section 250, Article 1013: Declaration of termination of taxable period. 28–19–617. O. D. 331.

Aliens having a status as residents of the United States and desiring to leave the United States temporarily will be required to show that all income tax obligations for the taxable year and prior years to the date of departure have been satisfied, and that provision has been made for payment of subsequent installments of tax as they become due; also that arrangements have been made for filing of returns and payment of tax for the succeeding year, should their absence extend beyond the time for filing such returns and paying the tax.

Section 250, Article 1013: Declaration of termination of taxable period. 28–19–618. O. D. 332.

For the purpose of the Revenue Act of 1918, the Virgin Islands are to be regarded as foreign territory. Rulings relative to citizens and aliens departing from the United States are therefore applicable to persons who plan to go to those islands, but citizens of the Virgin Islands who reside in the United States and plan to go to the islands are to be treated in the same manner as citizens of the United States in the matter of satisfying income tax obligations to the United States before departing from this country.

Section 250, Article 1013: Declaration of termination of taxable period. 13–19–429. M–2195.

Uniform procedure for collecting income tax from aliens seeking passage abroad.

On account of the unusual exodus of aliens from the United States following the armistice agreement and the treaty of peace, it becomes necessary to outline uniform procedure as to the manner in which income tax should be collected from aliens seeking passage abroad.

Section 250 (g) of the Revenue Act of 1918 provides in part as follows:

> If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer terminated at the end of the calendar month then last past and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable.

In order that the provisions of the foregoing section may be strictly enforced with the least possible friction and discomfort to persons who are returning to their native land, the following rules have been outlined:

Aliens, whether resident or nonresident as to the United States, who desire to depart from this country should appear before the collector of internal revenue for the district in which the individual last resided and should satisfy all income tax obligations with respect to income received up to and including the preceding month.

In computing the tax liability of any person whose taxable period is terminated in accordance with section 250 (g), the taxpayer is entitled to the same personal exemption and credit for dependents as he would have been entitled to had the return been prepared for the full taxable year. (See art. 1013, Reg. No. 45.)

If any income tax has been withheld from wages or other income of an alien, credit therefor should be given to the taxpayer when computing the balance of income tax due the United States Government.

An alien who is a resident for income tax purposes during the year 1918 but decides in 1919 to return to his native country, should be classified as a nonresident alien for the taxable period of 1919. This is not to be construed as depriving an alien of his status as a resident in case his absence is only temporary. A resident alien with children abroad is not a head of a family. A resident alien with a wife residing abroad is not entitled to the joint exemption. A nonresident alien is entitled to personal exemption and credit for dependents only in case he is a subject of a country which imposes no income tax, or in imposing an income tax allows similar credits to citizens of the United States not residing in such country. For a list of the countries, see article 307, which will be supplemented by a list of additional countries when the data are available.

An alien appearing before the collector of internal revenue should be questioned as to his earnings for 1916, 1917, 1918, and 1919, and the collector, in accordance with the information furnished, should execute Form 1040 C. The form shows the amount of tax due for the taxable period in 1919, as well as the income and amount of tax for prior years. On the bottom of the return is printed a certificate of compliance. This return should be executed in duplicate by the alien, and the certificate of compliance should be signed by the collector of internal revenue. The alien should retain the duplicate copy and should present it to the internal revenue agent in charge at the port of embarkation for a sailing permit. Sailing permits will only be issued by internal revenue agents at the port of embarkation.

SAILING PERMIT—UNITED STATES INTERNAL REVENUE.

This is to certify that—

Name____

City____________________ State________________________

has complied with all requirements of the Revenue Act of 1918 and the Acts for prior years.

(Signed)____________________________

Internal Revenue Agent.

An American citizen applying for a sailing permit should satisfy the internal revenue agent in charge that he has paid all installments of income tax due up to the date of departure, and has made arrangements for the payment of future installments as they become due. It will not be necessary to declare the taxable period of a citizen of the United States closed as provided in section 250 (g) of the Revenue Act of 1918, unless the agent has reason to believe that the departing citizen intends evasion of his income tax liability for 1919.

In accordance with an agreement with the officials of steamship companies which operate ships entering into United States ports, steamship officials will require persons applying for overstamping of tickets to produce a sailing permit signed by the proper internal revenue officer.

In cases where an alien has failed to appear before the collector of internal revenue for his district prior to seeking passage to a foreign country, it will be necessary for him to appear before the collector of internal revenue for the district in which the port of embarkation is located in order to satisfy his income tax obligations. Pending the issuance of printed forms for nonresident aliens, Form

1040C having printed thereon the certificate of compliance, the collector of internal revenue will prepare, with necessary adjustments, Form 1040A in duplicate, attaching to the duplicate a certificate of compliance. The worksheet of Form 1040A may be used as a duplicate, to be retained by the alien.

EXAMINATION OF ALIENS.

When examining aliens in the office of collectors of internal revenue, they should be questioned substantially as follows: (*a*) By whom employed, length of time, amount earned, amount of tax withheld, supported by letter from employer. (*b*) Married or single, and if former, is wife in this country. (*c*) If not employed for any part of the year, give reasons and how supported while unemployed. (*d*) Information as to nature of work performed should be secured as correctness of amount of income may be determined by standard prices paid for labor. (*e*) Information as to amount of money sent abroad should also be obtained and, if necessary, be verified through local bankers or steamship company.

Section 251.—RECEIPTS FOR TAXES.

Section 251, Article 1021: Receipts for tax payments. 8–19–332. T. D. 2874.

1. *Receipts to taxpayers—Duty to issue.*—The fact that section 251 of the Act of February 24, 1919, requires that full written or printed receipts be issued to taxpayers only on request therefor does not limit the collector's mandatory duty to issue them when requested and does not fail to make them documents required to be issued whenever requested, and the receipts are plainly documents required to be issued by such section.

2. *Same—Simulation or fraudulent execution.*—Such receipts are documents required by provisions of the internal-revenue laws and by regulations made in pursuance thereof within the meaning of section 3451, Revised Statutes, making it an offense to simulate or falsely or fraudulently execute or sign any document required by the internal revenue laws, or any regulation made in pursuance thereof, or to procure the same to be falsely or fraudulently executed, or to advise, aid in, or connive at such execution thereof.

3. *Same—Blanks.*—The offense may be committed either where the receipt itself is a genuine receipt of the kind kept for that purpose in the office of the internal revenue collector, but signed by the defendant without authority, or where, even if not a blank of the kind required to be kept, the blank itself is simulated or falsely or fraudulently executed and issued by a person who has no power or authority to do so.

4. *Same—Income tax receipts.*—Where defendant was charged with violating section 3451, Revised Statutes, in that he falsely, fraudulently, etc., simulated and executed and advised, aided in, and connived at the execution of certain income tax receipts required by section 251 of the Act of February 24, 1919, to be given when requested, what defendant told the persons who paid the money is not material, nor is the question whether or not such persons were subject

to the payment of an income tax, or to assessment and levy of such tax.

Section 252.—REFUNDS.

Section 252, Article 1032: Claims for abatement of taxes erroneously assessed. 31–19–652. O. 957.

INCOME, WAR PROFITS, AND EXCESS PROFITS TAXES—SECTION 3218, REVISED STATUTES, AND SECTION 252, REVENUE ACT OF 1918.

It is within the discretion of a collector of internal revenue to require a bond as a condition of the suspension of the collection of the tax where a claim for abatement of the tax has been filed.

Only an amount of income, war profits, or excess profits tax which has been actually found to have been paid in excess of what was properly due can be credited against income, war profits, or excess profits taxes due from the taxpayer under any other return.

The questions are raised whether a collector of internal revenue is authorized to require a bond from the taxpayer as a condition of the suspension of the collection of the tax pending the decision upon a claim for abatement and whether the amount claimed to have been erroneously collected can be credited, prior to the decision of the claim, against taxes due from the taxpayer under another return.

Section 3218 of the United States Revised Statutes provides:

Every collector shall be charged with the whole amount of taxes, whether contained in lists transmitted to him by the Commissioner of Internal Revenue, or by other collectors, or delivered to him by his predecessor in office, and with the additions thereto, * * * and he shall be credited with all payments into the Treasury made as provided by law, * * * and with the amount of taxes contained in the lists transmitted, in the manner heretofore provided, to other collectors, and by them receipted as aforesaid; also with the amount of taxes of such persons as may have absconded, or become insolvent, prior to the day when the tax ought, according to the provisions of law, to have been collected, and with all uncollected taxes transferred by him, or by his deputy acting as collector, to his successor in office: *Provided*, That it shall be proved to the satisfaction of the Commissioner of Internal Revenue, who shall certify the facts to the [First] Comptroller of the Treasury, that due diligence was used by the collector. * * *

Section 252 of the Revenue Act of 1918 provides:

That if, upon examination of any return of income made pursuant to this act, * * * it appears that an amount of income, war profits, or excess profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war profits, or excess profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the tax payer. * * *

* * * * * * *

Under section 3218 of the Revised Statutes every collector is charged with the whole amount of taxes, whether contained in lists transmitted to him by the Commissioner of Internal Revenue or by other collectors, or delivered to him by his predecessor in office, and with the additions thereto, and he is credited only with all payments into the Treasury made as provided by law, and with the amount of taxes contained in the lists transmitted by him to other collectors and by them receipted for, and also with the amount of taxes of such persons as may have absconded or become insolvent prior to the day when the tax ought, according to the provisions of the law, to have been collected, and with all uncollected taxes transferred by him, or by his deputy acting as collector, to his successor in office, and this is conditioned upon proof, to the satisfaction of the Commissioner of Internal Revenue, who must certify to the fact, that due diligence was used by him in his endeavor to collect the tax.

In article 1032, Regulations 45, it is provided:

> The filing of a claim for abatement does not necessarily operate as a suspension of the collection of the tax or make it any less the duty of the collector to exercise due diligence to prevent the collection of the tax being jeopardized. He should, if he considers it necessary, collect the tax and leave the taxpayer to his remedy by a claim for refund.

There is no provision of law or of the regulations for crediting a collector with any amount of tax which he might be unable to collect by reason of a decrease in the assets of a taxpayer subsequent to the transmission of the list to him, and in no case is he relieved of liability for the amount of the tax in the absence of due diligence in endeavoring to collect it. While there is no provision of law expressly authorizing the collector to require a bond as a condition of suspending the collection of the tax, he is personally charged with the amount of the assessments made against taxpayers in his district and he is required to use due diligence in collecting such taxes. If he fails to exercise due diligence, it is clear that he becomes personally liable for any tax which may be lost through such failure. He may require the tax to be paid and leave the taxpayer to his remedy by a claim for refund, and if he see fit to suspend the collection of the tax in any case where a final collection may thus be jeopardized he does it at his own risk. It is within his discretion to protect himself by requiring the taxpayer to execute a bond in the amount of the tax the collection of which is postponed.

It has been suggested that under the provisions of section 252 of the Revenue Act of 1918 the taxpayer should be allowed a credit for any amount claimed in good faith to have been erroneously paid against taxes due from him under any other return, pending the decision upon such claim. Such procedure is manifestly not authorized by said section. It provides only for the allowance of the credit when "it appears that an amount of income, war profits, or excess profits tax has been paid in excess of that properly due." If this phrase standing by itself be capable of more than one interpretation, its interpretation here is fixed by the following provision that "The amount of the excess shall be credited against any income, war profits, or excess profits taxes or installment thereof then due from the taxpayer under any other return." It is only the amount of the excess which can be credited against assessments upon another return and the amount of the excess can only be known when the merits of the claim for refund have been determined. It is clear then that the word "appears" as used in this section is equivalent to "has been ascertained." This section therefore authorizes the credit only of the amount of taxes actually ascertained to have been paid in excess of those due against taxes due upon any other return.

It is accordingly held that it is within the discretion of a collector of internal revenue to require a bond as a condition of the suspension of the collection of tax where a claim for abatement of the tax has been filed, and only an amount of income, war profits, or excess profits tax which has been actually found to have been paid in excess of what was properly due, can be credited against income, war profits, or excess profits taxes due from the taxpayer under any other return.

Section 252, Article 1036: Claims for refund of taxes erroneously collected. 8–19–333. T. D. 2871.

T. D. 2871 amends article 1036, Regulations 45, as follows: The last two sentences are to be replaced by the following:

In certain cases of overpayment by taxpayers the collector may repay the excess after allowance by the Commissioner of a claim for refund made by the collector on Form 751. The cases in which refund is made through collectors are covered by specific provisions not herein incorporated. The Commissioner has no authority to refund on equitable grounds penalties legally collected.

Section 252, Article 1036: Claims for refund of taxes erroneously collected. 18–19–488. O.D. 472.

When a claim for refund is filed by aliens, resident or nonresident, on Form 46, a copy of the form upon which the alien was assessed and taxed should be attached to Form 46.

Section 252, Article 1036: Claims for refund of taxes erroneously collected.

(See 7–19–310; sec. 335.) Excess profits tax paid by partnership with respect to income received during 1918 can not be applied as credit to tax due from individual members for taxable year 1918.

Section 252, Article 1036: Claims for refund of taxes erroneously collected.

(See 30–19–643; sec. 223, art. 401.) Claim for refund of tax paid in advance or on the basis of a tentative return when correct net income insufficient to require a return.

Section 252, Article 1037: Suits for recovery of taxes erroneously collected. 9–19–347. T. D. 2882 (2).

Sums due the United States are a valid offset as against amount found due the taxpayer in suit against collector, though included therein are items which the Commissioner of Internal Revenue did not claim to be due the United States when considering the return for assessment purposes.

Where an action for money had and received is brought against a collector of internal revenue for the amount of an additional tax paid on net income, the taxpayer is entitled to recover only such amount as is in reality greater than the tax which should have been assessed under the law as properly interpreted and applied. The fact that the Commissioner in assessing the tax erroneously allowed some deductions for depreciation does not operate as an estoppel against the collector or against the United States, as it is well settled that no assessment of the Commissioner is necessary for the collection of the tax, at least in a direct action by the United States; nor does it make any difference that an assessment has been made, for in spite of the assessment and of the expiration of the period within which an amended assessment can be made, the United States may still sue for the amount actually due. It is immaterial that suit is in form against the collector, because the recovery in the end comes from the United States, so that even if the collector were personally estopped, that estoppel under the circumstances does not apply against the United States. The conclusion is reached therefore that sums due the United States as determined by the court in suit against a collector of internal revenue are a valid offset as against the amount found due the taxpayer, though such sums include items which the Commissioner did not claim to be due the United States when considering the return for purposes of assessment.

Section 253.—PENALTIES.

Section 253, Article 1041: Specific penalties. 13–19–430.
O. 893.

Ruling under Revenue Act of 1917.—Penalties against partnerships and individual partners.

Neither partnerships nor individuals when in default in connection with the excess profits tax law are subject to the penalties provided in section 1004 of the Revenue Act of 1917. The ad valorem penalty attached for failure to make returns is 50 per cent.

Section 253, Article 1041: Specific penalties. 1–19–108.
S. 931.

The giving of instructions or advice with the purpose and intent of inducing persons liable to make income returns or pay income tax to refrain from making such returns or paying such tax is an attempt to defeat the tax within the meaning of the statute, and those giving such instructions or advice are amenable thereto.

Section 253 of the Act of 1918 reads as follows:

That any individual, corporation, or partnership required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000. Any individual, corporation, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

Officers or members of a certain organization have issued advice or instructions to refuse to fill out income returns or pay income tax. The question is whether the persons giving such advice or instructions are within the statute.

The section imposes penal liability, and penal statutes are to be strictly construed. It is also the rule that the purposes of construction of a statute should be to find the intent of the lawmakers. Looking at the four corners of the section in question, there is some ground for concluding that it was aimed at persons who are required either to pay or collect a tax, and that persons who are not required to do either were not within the contemplation of the lawmakers. It might, therefore, be logically argued that, it being doubtful whether the statute was aimed at cases like the present, the persons in question ought, under a strict construction, to be given the benefit of the doubt and not charged with liability.

Such, however, is not the way the doctrine of strict construction is applied. "We are undoubtedly bound to construe penal statutes strictly and not to extend them beyond their obvious meaning by strained inference. On the other hand, we are bound to interpret them according to the manifest import of the words and to hold cases which are within the words and the mischiefs to be within the remedial influence of the statute." (The Schooper Industry, 1 Gall., 114, 117; Northern Securities Co. *v.* U. S., 193 U. S., 197, 359.) In other words, the doctrine of strict construction means that the language which is in fact used in a statute shall not be strained beyond its normal and usual meaning to include a case which is not covered by the language as it stands. It does not mean that the language shall be strained so as to exclude a case which is within its literal import.

Looking at section 253, we find the facts of the instant case to be directly within the literal language used. Such language is "An individual * * * who willfully attempts in any manner to defeat * * * the tax." Certainly the persons giving the advice or instructions in question have willfully attempted to defeat the tax. Certainly, also, a provision whereby such persons, and those who from different motives advise clients to adopt methods of account keeping, etc., whereby it is hoped the tax may be defeated, may be reached, is necessary, and it is not at all unreasonable to suppose that the framers of the Act had the deliberate purpose of reaching such persons, and that their case is therefore "within the mischiefs." At any rate, while the attempt should be to ascertain the intent of the lawmakers, the language used is always the best evidence of such intent. "It is not only the safer course to adhere to the words of a statute, construed in their ordinary import instead of entering into any inquiry as to the supposed intention of Congress, but it is the imperative duty of the court to do so." (Bate Refrigerating Co. *v.* Sulzberger, 157 U. S., 133.) "We must take the law as we find it upon examination of its language." (U. S. *v.* Gooding, 12 Wheat., 460, 478.) The case is within the words and the words are to be presumed to express the congressional intent.

Therefore, it is concluded that the giving of instructions or advice with the purpose and intent of inducing persons liable to make income returns or pay income tax to refrain from making such returns or paying such tax is an attempt to defeat the tax, within the meaning of the statute, and those giving such instructions or advice are amenable thereto.

Section 253, Article 1041: Specific penalties. 6–19–282.
O. D. 168.

If a citizen about to leave the United States willfully refuses to pay such tax as is properly due, he may be arrested and detained for the purpose of facing prosecution criminally for a violation of section 253 of the Revenue Act of 1918. Furthermore, the district courts of the United States, at the instance of the United States, are vested with jurisdiction to make and issue writs and orders of injunction and ne exeat republica and such orders and process as may be necessary or appropriate for the enforcement of the provisions of the Revenue Act of 1918. (Sec. 1318.) With respect to these provisions a citizen departing is in no different position from a citizen continuing in the United States—the Act being enforceable alike against taxpayers continuing in the United States and taxpayers departing from the United States.

Section 256.—INFORMATION AT SOURCE.

Section 256, Article 1071: Return of information as to payments of $1,000. 18-19-489. O. 907.

Section 3167 of the Revised Statutes as amended by section 1317 of the Revenue Act of 1918 is applicable to any income return, including returns made on Forms 1096 and 1099.

Where a corporation or its representatives fail to supply or make proper returns of information called for under section 256 of the Revenue Act of 1918, the penalties provided for under section 253 of said act may be invoked.

Section 256, Article 1074: Cases where no return of information required. 2-19-172. O. D. 115.

Rents paid in crop shares are not "fixed or determinable gains, profits, and income" to be reported in returns of information.

Section 256, Article 1076. Return of information as to payments to nonresident aliens. 1-19-110. O. D. 76.

Form 1099 is required in case of payment to a nonresident alien partnership of interest on bank deposits if the interest amounts to $1,000 or more.

Section 256, Article 1076: Return of information as to payments to nonresident aliens. 5-19-263. O. D. 162.

In cases where a foreign corporation is the registered owner of stock of a domestic corporation and the actual owner is a nonresident alien individual or partnership, disclosure of actual ownership should be made on Form 1087, revised, in order that a domestic corporation required to render a return of information as to dividends in accordance with section 254 of the act, may have at its disposal information as to actual ownership of the stock. The foreign corporation as the registered holder is not, however, required to render any return or withhold any tax from income paid to the actual owner of the stock, nor is there any provision under the Revenue Act of 1918 whereby any withholding of tax at the source is required by the debtor corporation with respect to such income whether actually owned by the registered owner or by a third party.

Nonresident alien individuals who are actual owners of stock registered in the name of a foreign corporation should render or cause to be rendered a return of income from sources within the United States, including dividends upon stock actually owned by them but registered in the name of the foreign corporation.

Section 256, Article 1078: Ownership certificates for foreign items. 31-19-653. O. D. 354.
(Also Section 221, Article 366.)

Nonresident alien individuals, partnerships, and corporations not engaged in trade or business within the United States and having no office or place of business therein, should file Form 1001-A properly modified, in connection with interest coupons on bonds of a corporation organized in the United States but which transacts no business in the United States and owns no property therein.

In cases where Form 1000 has been filed by nonresident alien bondholders, the certificate should be stamped as follows before being forwarded to the Commissioner of Internal Revenue, Sorting Division:

"Exempt—debtor corporation owns no property and does no business in the United States."

Section 257.—RETURNS TO BE PUBLIC RECORDS.

Section 257, Article 1091: Inspection of returns. 17-19-473.
(Also Section 221, Article 364.) O. 879.

Ownership Certificates, Certified Copies.

Ownership certificates are income returns within the meaning of section 3167, Revised Statutes, as amended. As they are filed as a result of income tax laws for the purpose of being used in connection with income tax returns they are to be treated as such under the regulations governing the furnishing of copies.

Ownership certificates have been required to be executed and filed under rules and regulations made pursuant to authority contained in the several income tax Acts. They were designed for the purpose of administering effectively the provisions of such Acts which required corporations to deduct and withhold from interest on certain of their securities owned by certain persons fixed percentages to be paid over to the Government as a part of the tax due from such persons.

Section 3167 Revised Statutes, as amended by the Revenue Act of 1918, provides:

> It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person * * * the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

Ownership certificates have been required to be made out by persons presenting interest coupons for payment. They show the name of the debtor corporation, the description of the security, and the interest rate, the date of maturity of interest, the amount of the interest due, and the signature of the maker, and his post-office address. After the payment of the interest to the maker of the certificates they are required to be filed with the department as a check against and therefore as a complement to the income tax returns of the makers. As they contain, among other things, a statement showing income of the maker and its source, they are clearly "income returns" within the meaning of section 3167, Revised Statutes, as amended. Being such it would be unlawful for any person to make known, in any manner whatever, not provided by law, any part thereof. The regulations contained in Treasury Decision 2016, dated July 20, 1914, provide how, when, and to whom copies of income tax returns, made pursuant to section 2 of the Act of October 3, 1913, may be lawfully furnished. By subsequent appropriate regulations they are made applicable to the provisions contained in the subsequent income tax Acts of September 8, 1916, and the Revenue Act of 1918. If ownership certificates are *income tax returns* copies may lawfully be furnished, as provided in these regulations. As they are *income returns*, designed for the purpose of being used in connection with the collection of income tax imposed by income tax laws, and to be filed as a complement to *income tax returns* required of the maker, they should be considered *income tax returns*. In Law Opinion 622 it was, in effect, held that *lists* furnished to supplement and become a part of income tax returns, are open to inspection the same as the returns themselves. That ruling is broad and includes such lists, whether or not they show income. The regulations permit furnishing copies of income tax returns to the maker of the returns. In Solicitor's Memorandum No. 739 it was held that a receiver of a corporation is as much entitled to a copy as the corporation itself. A duly constituted executor or administrator of the estate of a deceased person is his personal representative and following the reasoning in S–739 he is as much entitled to a copy of the return of the deceased as the maker himself. Where copies of ownership certificates are requested, for whatever purpose, we should look for authority to furnish them to the regulations contained in Treasury Decision 2016.

It is held that ownership certificates made by persons owning securities, showing income of the makers, which pursuant to law and regulations are filed with the department, are income returns, and as they are required to be filed as a result of income tax laws for the purpose of being a complement to income tax returns of the makers they should be treated the same as *income tax returns* are treated under the regulations governing the furnishing of copies of such tax returns.

Section 257, Article 1091: Inspection of returns. 14–19–439.
O. 897.

LISTS OF INDIVIDUALS MAKING INCOME TAX RETURNS.

The Commissioner of Internal Revenue may lawfully cause to be prepared from stencils in the offices of the several collectors of internal revenue in a State, a list or lists containing the names and post-office addresses of individuals making income tax returns to the several collectors and may cause them to be placed in the office of officials

charged with the collection of State income tax, to be there available for public inspection. The authority does not extend to lists of partnerships or fiduciaries; inspection of corporate returns by State officers is governed by another provision of law.

Opinion is requested whether a list of the names and post-office addresses of persons making income tax returns for the year 1918 to the collectors of internal revenue for a State may lawfully be furnished the officer of the State who is charged with the collection of income taxes imposed by that State.

An officer of a State has requested such a list containing the names and addresses of individuals, partnerships, and fiduciaries who filed income tax return in that State for the year 1918. It is represented that the collector of internal revenue in that State now has in his office in stencil form the information desired and that the purpose of the officer will be served if each collector be permitted to have a list of the individuals filing returns made from the stencils upon cards to be supplied by the comptroller.

Section 3167, Revised Statutes, as amended by the Revenue Act of 1918, makes it unlawful for anyone "to divulge or to make known in any manner whatever not provided by law to any person * * * the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth, or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; * * *" "or to print or publish in any manner whatever not provided by law any income return or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; * * *."

"Any abstracts or particulars" or "any part" of "any income return" are comprehensive enough to include the names and addresses of the makers when they are taken from such returns. The evident purpose of this provision is to cause to be held in confidence and not to be divulged anything in the way of information, including the names and post-office addresses of the makers, contained in income returns, unless there is specific provision of law for making it known.

It is provided in section 257 of the Revenue Act of 1918 that—

The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal revenue district and in such other places as he may determine, lists containing the names and post-office addresses of all individuals making income tax returns in such district.

This provision is directly and manifestly designed for one purpose, namely, making the lists available for *public inspection* which implies that any and every one may inspect them. It does not provide for furnishing a list to an individual for his exclusive use or to a State officer for his exclusive official use, and there is no other provision of law for furnishing such a list.

By section 257 the Commissioner may determine the manner in which the lists may be prepared and made available for public inspection, and also the places (other than in the collector's office) he will make them so available. He may therefore legally cause the lists to be prepared on cards from stencils in the collector's office and to be made available for *public inspection* in the office of a State officer. In this way the State officer may, with others, inspect the lists in his office, and make, if he desires, copy of such lists for his personal or official use. The lists authorized by section 257 are to contain only the names and addresses of *individuals* making income tax returns. The authority does not extend to partnerships or fiduciaries.

It is held that under authority contained in section 257 of the Revenue Act of 1918 the Commissioner may lawfully cause to be prepared from stencils in the offices of the several collectors of internal revenue a list or lists containing the names and post-office addresses of individuals making income-tax returns to the several collectors and may cause them to be placed in the office of officials charged with the collection of State income taxes, to be there available for public inspection. The authority does not extend to lists of partnerships or fiduciaries; inspection of corporate returns by State officers is governed by another provision of law.

Section 257, Article 1091: Inspection of returns. 27–19–607. O. D. 325

Under the regulations governing inspection of income tax returns, if a taxpayer renders a joint return in behalf of himself and his wife, copies of the return may be furnished only to the person rendering the return or to his duly constituted attorney.

Section 257, Article 1091: Inspection of returns. 31–19–654. O. D. 355.

The executor of an estate may secure copies of income tax returns filed by the decedent upon submission to the Commissioner of a certified copy of letters testamentary evidencing his appointment as executor.

Section 257, Article 1092: Inspection of returns by State. 1–19–112. O. D. 78.

It is held that the returns of citizens or residents of any State may not be inspected by State officials for the purpose of obtaining information in connection with State income tax laws.

Section 257, Article 1093: Inspection of returns by stockholder. 18–19–490. O. D. 273.

A "stockholders' protective committee," to which deposited stock has been transferred for the purpose of safeguarding the interests of the minority stockholders, is not considered a bona fide stockholder within the meaning of section 257 of the Revenue Act of 1918.

Section 257, Article 1094: Penalties for disclosure of returns. 15–19–451. T. D. 2903.

INFORMATION CONTAINED IN RETURNS.

Laws relating to the giving out, by employees of the Bureau of Internal Revenue, of information contained in returns filed by taxpayers or in reference to office procedure with respect to the auditing of returns, handling of claims, and similar lines of work.

Your attention is directed to the following legislation relating to the divulging of information contained in the returns of taxpayers.

Section 257 of the Revenue Act of 1918 provides:

That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President: *Provided*, That the proper officers of any State imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof, showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: *Provided further*, That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries.

Section 3167, Revised Statutes, as amended by section 1317 of the said Revenue Act of 1918, provides:

It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States, to divulge or to make known in any manner whatever not provided by law to any person the operations, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof, or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

Section 3152, Revised Statutes, as amended by the Act of March 1, 1879, authorizing the employment of internal revenue agents, also provides:

And all provisions of sections thirty-one hundred and sixty-seven, * * * of the Revised Statutes shall apply to internal revenue agents as fully as internal revenue officers.

Section 3173 of the Revenue Act of 1918 provides that—

It shall be the duty of any person, partnership, firm, or association, or corporation, made liable to any duty, special tax, or other tax imposed by law, when not otherwise provided for, (1) in case of a special tax, on or before the thirty-first day of July in each year, and (2) in other cases before the day on which the taxes accrue to make a list or return * * *: *Provided*, That if any person liable to pay any duty or tax, or owning, possessing, or having the care or management of property, goods, wares, and mechandise, articles, or objects liable to pay any duty, tax, or license, shall fail to make and exhibit a list or return required by law, but shall consent to disclose the particulars of any and all the property, goods, wares, and merchandise, articles, and objects liable to pay any duty or tax, or any business or occupation liable to pay any tax as aforesaid, then, and in that case, it shall be the duty of the collector or deputy collector to make such list or return. * * *

Section 3176, Revised Statutes, as amended by said section 1317, Revenue Act of 1918, further provides:

If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may from his own knowledge and from such information as he can obtain through testimony or otherwise make a return or amend any return made by a collector or deputy collector.

Reading these provisions of law together, it is evident that any collector, deputy collector, agent, clerk, or other officer or employee of the Bureau of Internal Revenue, including internal-revenue agents, who divulges or makes known in any manner whatsoever not provided by law the amount or source of income, profits, losses, expenditures, or any particulars thereof set forth or disclosed in any income return made by any taxpayer, or by a collector or deputy collector, or by the Commissioner of Internal Revenue, or who permits any income return or copy thereof, or any book containing any abstract or particulars thereof, to be seen or examined by any person, except as provided by law, or who prints or publishes in any manner whatever, not provided by law, any income return or any part thereof, or source of income, profits, losses, or expenditures appearing in any income return, is guilty of a misdemeanor and subject to a fine not exceeding $1,000 or to imprisonment not exceeding one year, or both, at the discretion of the court; and if he be an officer or employee of the United States, to be dismissed from office or discharged from employment.

The only provisions of law authorizing the making known of any income return under the Revenue Act of 1918 are those contained in section 257 of said Act, above quoted.

Similar provisions to those contained in section 257, Revenue Act of 1918, and sections 3173 and 3176, as amended by said Revenue Act of 1918, were also contained in the Act of October 3, 1917, and the Act of September 8, 1916.

Section 260.—CITIZENS OF UNITED STATES POSSESSIONS.

Section 260, Article 1121: Status of citizen of United States possession. 28–19–619. O. D. 333.

Citizens of the Virgin Islands who are not otherwise citizens of the United States and who are not residents of the United States are taxed only on income from sources within the United States. Citizens of the Virgin Islands who are residents of the United States are taxed on the same basis as other citizens of the United States.

Title III.—WAR PROFITS AND EXCESS PROFITS TAX.

Part II.—Imposition of Tax.

Section 301.—IMPOSITION OF TAX.

Section 301, Article 714: Computation of tax on income from Government contracts. — 1–19–113. T. B. M. 4.

In the case of a fiscal-year corporation the computation under section 301 (c) (1) should be based on the entire net income for the fiscal year even though no part of the income from Government contracts was derived after January 1, 1919.

The following question has been submitted:

In the case of a fiscal-year corporation should the excess tax for 1919 based on income from a Government contract be prorated to apply only to income attributable to that contract in 1919, or should the tax be computed on the basis that the income was received throughout the fiscal year?

The computation under section 301 (c) (1) of the Revenue Act of 1918 should be based on the entire net income for the taxable year, or, in other words, should be on the basis that the income was received throughout the fiscal year. In the judgment of the board any other ruling would be in conflict with the express provisions of the statute. It is a fundamental principle of the application of the provisions of the several acts relating to fiscal years that no adjustment should be made even though it can be definitely shown what proportion of the income was derived during each portion of the fiscal year.

Section 301, Article 714: Computation of tax on income from Government contracts. — 28–19–620. A. R. M. 5.

If a corporation has a net income from a Government contract and sustains a net loss from other operations in the submission of a fiscal year return for a period ending in 1919, the loss may be deducted from the income from the Government contract.

Inquiry is as to the amount of net income to be taxed in the case of a fiscal-year corporation submitting a return for a period ending in 1919 if there is profit from a Government contract and loss from other operations.

Section 301 (c) of the Revenue Act of 1918 provides:

For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation which derives in such a year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following: * * *

It is to be noted that the tax is upon the net income of the corporation. The prorating in parts 1 and 2 of paragraph (c) of this section is purely for computation purposes. Accordingly, it is recommended that a corporation having a net loss from operations other than those relating to Government contracts, and a profit from Government contracts, be permitted to deduct the loss in order to ascertain the net income upon which the tax is to be computed.

Section 301, Article 714: Computation of tax on income from Government contracts.

(See 24-19-557; sec. 1, art. 1510.) Income from amended Government contract.

Section 301, Article 715: Allocation of net income to particular source. 26-19-597.
(Also Section 214, Article 181.) A. R. M. 1.
(Also Section 234, Article 561.)

If exact determination of income arising from Government contracts distinctively from other income is impossible, an approximation based on the proportion which sales to the Government bears to other sales should be used only in case approximations based on the respective cost and selling price are inapplicable. The approximation should be based upon the allocation of costs and allocation of selling price, in the most accurate manner possible from available records.

Amortization is not to be charged exclusively against income from Government contracts, and selling and administrative expenses not applicable to the Government contracts should not be so charged.

Representatives of the M Company state that it is impossible to ascertain profits from Government orders separately from profits on civilian orders, and ask:

(*a*) What method of apportionment of these profits is to be used in submitting a return for fiscal year ending June 30, 1919?

(*b*) What disposition is to be made of an amount claimed for amortization?

The answer to the first is that when profits can not be definitely allocated as to a Government contract, the proportion which the sales from the Government contract bears to the total sales is the proportion of income which is deemed to have arisen from the Government contract.

This answer presents a fair approximation under the following circumstances:

(*a*) If all articles made are of the same size, or grade, or if not, if the proportion sold to civilian trade of each kind is the same as the proportion sold to the Government.

(*b*) If the articles on hand at the beginning of the year cost the same as those manufactured during the year, or if the same proportion were sold out of those on hand at the beginning to civilians as were sold to the Government, or if all orders were filled exclusively either out of the ones on hand at the beginning or out of the ones manufactured during the year.

(*c*) If the prices charged the Government are identical with the prices charged the civilian trade.

The presence of all of these elements is so improbable that the Committee deems that the method proposed should be utilized only in case other methods likely to afford a closer approximation are inapplicable.

There is a probability that the inquiry was prompted by the fact that it is impossible to determine the exact cost of lots of articles made on Government contracts as distinguished from the exact cost of lots of articles made for civilian trade. Records may be available to an extent which will enable an approximation of the unit costs and selling prices from which an allocation may be determined. By working from the costs standpoint a method of closer approximation may be found.

In taking inventories of the stock on hand there should have been some method of ascertaining the unit price of articles that is reasonably accurate. This would apply as to articles of different kinds and grades, as well as to a condition in which the articles were all of the same kind and grade.

It is likely that articles made during the year were not made at the same costs as those on hand at the beginning. Accordingly, the first step would be to ascertain which of the articles on hand at the beginning were sold to the Government and which to civilian trade. If not otherwise accurately ascertainable, it is suggested that this be determined by assuming that the first articles delivered during the fiscal year were delivered out of inventory, by taking the dates of delivery, respectively, to the Government and to the civilian trade, and apportioning these articles accordingly, having in mind, of course, the different grades and sizes. The selling price of these articles would be offset by the value at which inventoried, so that the profit could be determined.

If the records are as incomplete as the letter of inquiry indicates, it is hardly likely that the costs of finishing the articles in process of manufacture at the beginning of the year can be determined separately from the costs of articles which were placed in manufacture and completed during the year. Nevertheless, the ordinary manufacturing and trading statement usually gives the costs of goods completed during the year. Inasmuch as it is essential that these costs be allocated, if the proper inventory is made as to grades and sizes it is likely that the records will contain sufficient information to show the total manufacturing costs of each kind and grade of articles completed during the year. The value of the articles sold, as to kind and grade, is then easily ascertainable by deducting the closing inventory. The proportion sold to the Government to the total sold, as to each kind, affords basis for determining the costs of each kind sold to the Government. These costs, deducted from the selling price of each kind, would give the gross profit on Government contracts as to articles manufactured during the year, which, added to the gross profit from those delivered out of opening inventory, should give the total gross profit.

Assuming other expenses can not be properly apportioned as to each source of income, then the proportion which the gross income from the Government contracts bears to the gross income from other sources determines the basis of apportionment.

In answering the second query, it is believed that the taxpayer's representatives should be informed that amortization is not exclusively chargeable against the profits made on the Government contract, and that part of this amortization is probably applicable to the fiscal year ending June 30, 1918. As to selling and administrative expenses, it should be borne in mind that part of these may be exclusively applicable to articles sold to civilian trade—as, for example, costs of selling organization and of advertising, which are not ordinarily essential to the procurement of Government contracts.

Section 301, Article 719: Illustration of computation where net income derived from Government contract. 20–19–517. O. D. 281.

Method of computing the war profits and excess profits taxes in the case of a corporation which has income during a fiscal year ended in 1919 in excess of $10,000 from Government contracts made between April 6, 1917, and November 11, 1918.

(1) The tax for the full fiscal year shall first be computed at the 1918 rates as if the fiscal year were the calendar year 1918. The same proportion of the tax so computed, which the income derived from Government contracts is of the total income from all sources, represents the tax due on the income from the Government contracts.

(2) To compute the tax at the 1918 rates on the net income derived from sources other than Government contracts, the tax attributable to Government contracts is first deducted from the total tax computed at the 1918 rates, and the difference is reduced to the proportionate part thereof that the number of months of the fiscal year falling within 1918 is of the full fiscal year.

(3) The tax must then be computed on the entire income from all sources for the full fiscal year at the 1919 rates. The same proportionate part of this tax is taken as the net income from sources other than Government contracts is of the total net income. This amount is then reduced to the same proportionate part thereof that the number of months of the fiscal year falling within 1919 is of the full fiscal year.

The sum of the results obtained in following the procedure outlined in the three preceding paragraphs will be the total tax.

For example: Assume a corporation having a total net income of $120,000 for the full fiscal year ended March 31, 1919, $48,000 of which was derived from Government contracts. Assume further that the total war profits and excess profits tax computed at the 1918 rates is $60,000, and the total war profits and excess profits at the 1919 rates is $30,000.

The tax attributable to Government contracts would be two-fifths of $60,000, or $24,000. Deducting this amount from $60,000 leaves $36,000. The tax on the remaining net income at 1918 rates would be three-fourths of $36,000, or $27,000.

Applying the 1919 rates to the income not attributable to Governcent contracts would result in a tax of three-fifths of $30,000, or $18,000; but since only three months of the return period falls within 1919, the tax would be one-fourth of $18,000, or $4,500. The total war profits and excess profits tax would, therefore, be the sum of $24,000, $27,000, and $4,500, or $55,500.

The computation necessary to arrive at this result should be shown in a supplementary statement attached to the return. These computations will not apply to the income tax, which will be computed on the entire net income, as provided in section 205 (b) of the Act. In the illustration given, the amount of war profits and excess profits tax to be credited against net income, in computing the income tax at both the 12 per cent and 10 per cent rates, would be $55,500, as computed above.

Section 302.—LIMITATION OF TAX.

Section 302, Article 731: Short form of computation of limitation. 1–19–115. O. D. 80.

The tax limitation prescribed in section 302, Revenue Act of 1918, is applied to the consolidated net income and may not be construed to apply separately to the net income of each unit included in the return.

Section 303.—TAX WHEN PARTLY PERSONAL SERVICE BUSINESS.

Section 303, Article 741: Apportionment of invested capital and net income. 12–19–410. T. B. M. 50.

Where a corporation doing a commission and brokerage business satisfies the requirements of a personal-service corporation, except that it in part employs capital, surplus, and borrowed funds to make large advances to customers and receives more interest than it pays as a result of such transactions, it should be assessed under section 303. The income from commissions and brokerage should be considered as arising from personal service, and the remainder of the income as derived from the use of capital.

Section 303, Article 741: Apportionment of invested capital and net income. 1–19–114. O. D. 79.

Section 303 of the law will apply in the case of partial personal-service corporations until the point is reached where the nonpersonal-service element becomes negligible, under which conditions such corporations would make returns as personal-service corporations, as set out in section 218 of the law.

Part III.—Credits.

Section 311.—WAR PROFITS CREDIT.

Section 311, Article 781: War profits credit. 5–19–264. T. B. R. 16.

Method of ascertaining a corporation's average net income and average invested capital for the prewar period where corporation closes its books on the basis of a fiscal year which differs from the calendar year.

The Income Tax Unit has requested a ruling as to the method by which a corporation is to ascertain the average net income and the average invested capital for the prewar period as called for in section 311 (2) in cases where a corporation closes its books on the basis of a fiscal year differing from the calendar year. The prewar period is defined in section 310 of the Revenue Act of 1918, which reads: "That as used in this title the term 'prewar period' means the calendar years 1911, 1912, and 1913, or, if a corporation was not in existence during the whole of such period, then as many of such years during the whole of which the corporation was in existence." The problem presented by the inquiry of the Income Tax Unit is as to how the fiscal year periods are to be made to conform to the calendar years specified for the prewar period.

It is recommended that the computation be made as follows:

The starting point for each year is the beginning of the fiscal year ending in 1911, 1912, and 1913, respectively, and the invested capital should be ascertained as at those dates. To these sums should be added any contributions of capital between the beginning of each such fiscal year and January 1, 1911, 1912, and 1913, respectively, and corresponding deductions should be made in respect of any dividends and any refunds of capital during those respective periods. To these balances should be added a pro rata share of the earnings of the respective fiscal years, and the totals thus arrived at will be deemed to be the invested capital of the taxpayer at January 1, 1911, 1912, and 1913, respectively. Taxpayers should file with their returns copies of their balance sheets at the beginning of each fiscal year and a schedule for each year showing the adjustments made in computing the invested capital as at the beginning of each calendar year during the prewar period.

Where a taxpayer has such accounting records as will enable him to prepare an accurate balance sheet showing the true surplus and undivided profits at the beginning of each one of the prewar calendar years and an accurate income account for such years, he may make the computation upon this basis and explain the method used in such detail as will enable the Commissioner of Internal Revenue to determine whether such basis is proper.

Where a taxpayer has not been in business during the whole of the prewar period the above methods will be applicable to such full calendar years during the whole of which years the taxpayer was in business.

Section 311, Article 781: War profits credit. 8–19–319.
(Also Section 214, Article 106.) O. D. 184.
(Also Section 326, Article 841.)

Corporations are not allowed at this late date to adjust salaries paid during the prewar period when such adjustment is made solely for the purpose of increasing the war profits credit for the taxable year..

Part IV.—Net Income.

Section 320.—NET INCOME.

Section 320, Article 801: Net income. 8–19–335.
T. B. M. 42.

With respect to the inquiry whether or not value appreciation of property taken up on the books of the taxpayer and returned as a part of his taxable income for the year in which the appreciation was written up may be included as a part of the income for the prewar period, a negative reply must be given. Appreciation is not and has not been at any time under the income tax laws proper taxable income, and where such appreciation has been taken up on the books of the taxpayer the item must be excluded in computing income, even though an income tax has been paid upon it.

Section 320, Article 801: Net income.

(See 21–19–520; sec. 201, art. 1541.) Excess profits tax under 1917 law on dividends from foreign corporations.

Part V.—Invested Capital.

Section 325.—TERMS RELATING TO INVESTED CAPITAL.

Section 325, Article 812: Borrowed capital: Securities. 27–19–609. S. 1200.

Preferred stock, if in the records of the corporation it is declared to be part of its capital stock, though convertible into first-mortgage bonds of even date therewith, is inferior, on a distribution of assests to pay debts, to the rights of general creditors, and is to be treated as invested capital so long as it is not converted.

Opinion is requested as to the status of stock designated as "first preferred stock" under the following sections of the Revenue Act of 1918.

Section 325 (a) provides:

The term "borrowed capital" means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise.

Section 326 (b) provides:

As used in this title, the term "invested capital" does not include borrowed capital.

The following facts are presented: The M Company, a corporation by an amendment to its articles of incorporation and pursuant to a resolution of its stockholders duly adopted, increased the amount of its capital stock from 18x dollars to the sum of 45x dollars, of which y shares were to be preferred. Certificates of "first preferred stock" were issued, which contained a provision that the shares of stock should be convertible at the election of the holder into first mortgage gold bonds. At the time the preferred stock was issued, the directors provided for an issue of coupon bonds, secured by a first mortgage or trust deed. Said bonds and trust deed were of even date with said certificates of preferred stock. The trust deed was executed, delivered to the trustee and placed on record. It contains the provision that "said bonds shall be held by said trustee and its successors until issued and shall be issued and used only for the purpose of being exchanged, par for par, for shares of preferred stock."

The specific question is:

Is first preferred stock which, at the election of the holder, is convertible into bonds, of even date therewith and secured by a first mortgage trust deed—such bonds to be issued only for the purpose of converting such preferred stock—to be treated as invested capital or as borrowed capital?

The rights of holders of preferred stock which represents a part of the capital stock of a corporation, and is secured by a trust deed or otherwise, are inferior to the rights of general creditors. (Westerfield-Bonte *v.* Burnett, Ky., 195 S. W. 479; Miller, executor, *v.* Batterman, treasurer, 47 Ohio St. 141, 24 N. E. 146; Booth *v.* Union Fiber Co., Minn., 162 N. W. 677; same case on rehearing, 171 N. W. 307; Spencer *v.* Smith et al., 201 Fed. 674; Armstrong *v.* Union Trust

& Savings Bank, 248 Fed. 269.) Whether persons who contribute or make payments to a corporation are stockholders or creditors of the company is a question to be determined by the intention of the parties as disclosed by the circumstances. (Miller, executor, *v.* Batterman, treasurer, 47 Ohio St. 141, 24 N. E. 496.) Persons who negotiate for and acquire preferred stock "designed as," and "declared to be," a part of the capital stock of a corporation are held to full knowledge of the character of their investments. From such facts it is conclusively presumed that the parties intend such persons to be stockholders—preferred stockholders—and not creditors (Armstrong *v.* Union Trust & Savings Bank, 248 Fed. 268).

In the case of Spencer *v.* Smith et al., 201 Fed. 647, the court held that the rights of general creditors were superior to those of a preferred stockholder, whose certificate contained an agreement by the corporation to redeem the amount thereof at a specified time, which agreement was presently secured by a first mortgage lien of the corporate property. Assuming, in the instant case, that the mortgage bonds and trust deed securing same were in effect a present security for such stock, the case would then be no stronger than that under consideration in Spencer *v.* Smith et al., above, at least until such stock is converted into bonds.

It appears that the taxpayer, by amending its articles of incorporation, fixed its capital stock at 45x dollars, of which y shares were to be preferred. The first preferred stock was therefore designed as, and was directly declared to be, a part of the capital stock of the corporation. These facts are identical, apart from the amounts stated, with the facts in the case of Armstrong *v.* Union Trust & Savings Bank, cited above. Upon a purchase of stock, under these circumstances, the intention of the parties is conclusively presumed to be that such purchasers become stockholders and, on a distribution of assets to pay debts, their rights are inferior to creditors.

It is concluded that the preferred stock under consideration in the instant case is part of the capital stock of the corporation and that the rights of the holders thereof are inferior to the rights of general creditors. Determined by the rule stated in article 812, Regulations 45, such preferred stock is, therefore, invested capital and not borrowed capital.

It is held that preferred stock, if in the records of the corporation it is declared to be part of its capital stock, though convertible into first mortgage bonds of even date therewith, is inferior, on a distribution of assets to pay debts, to the rights of general creditors, and is to be treated as invested capital so long as it is not converted.

Section 325, Article 813: Borrowed capital—Amounts left in business. 23-19-552. T. B. M. 82.
(Also Section 201, Article 1542.)

Excess profits tax—Surplus paid in by stockholders.

The M Company was organized in 1910 with a capital stock of 10x dollars. Such stock was subscribed for as follows: A, all but 2 shares; B, 1 share; and C, 1 share. All the capital represented by this stock was actually furnished by A; the other stockholders holding their stock for him. No change in stock ownership took place, and during 1915 A paid into the company 7x dollars. No action was taken by the corporation which would indicate the nature of this payment, except that it was entered upon the company's books as a contribution to capital and was never treated as an account payable. No stock was issued and no interest was charged on this amount. During 1917 this money was repaid by the corporation to A. No evidence is presented to indicate the nature of this payment or how it was treated by the corporation. The company contends that this sum should be included in invested capital for the proper part of the year 1917.

It is evident that the formalities of proper corporate action have in this case been disregarded. This makes a determination of the exact relation between A and the corporation with reference to the 7x dollars very difficult. Article 813, Regulations 45, contains the general principle:

> That if interest is paid or is to be paid on any such amount, of if the stockholders' or officers' right to repayment of such amount ranks with or before that of the general creditors, the amount so left with the corporation must be considered as borrowed capital and be so treated in computing invested capital.

It is accepted legal doctrine that where stockholders voluntarily assess themselves to relieve the corporation from pecuniary embarrassment or for the betterment of their stock, whatever may be the occasion of the assessment, the advances thus made are not debts against, but assets of, the corporation. (Broderick *v.* Brown, 69 Fed., 497.)

It is the opinion of the Advisory Tax Board that this payment was in the nature of a voluntary assessment by the one who was practically the sole stockholder of the corporation, and that after it was paid to the corporation no obligation to repay it existed. The treatment of this payment by the corporation upon its books (undoubtedly with the knowledge of A) is highly significant and would undoubtly postpone A to the general creditors of the corporation as to this amount. The repayment of this sum in 1917 to the stockholder must be deemed to be out of undivided profits or earned surplus so far as possible. (Section 31 (b), Revenue Act of 1916, as amended.) While this distribution was informal, it can not be treated as a return of capital unless the undivided profits and earned surplus accumulated since 1913 are first distributed as dividends. Whether or not such repayments will reduce the invested capital will depend upon the amount of current earnings available for distribution at the time of such repayment.

It is therefore recommended that the M Company be permitted to include in its invested capital for the taxable year 1917 the sum of 7x dollars as a surplus paid in by the stockholders, proper adjustment being made for any distribution of dividends in excess of available net earnings.

Section 325, Article 815: Inadmissible assets. 1–19–116.
(Also Section 213, Article 77.) O. 781.

War Finance Corporation Bonds—"Admissible Assets."

Interest on an amount of bonds of the War Finance Corporation, the principal of which does not exceed in the aggregate $5,000, is exempt from Federal income and excess-profits taxes. Corporate funds invested in such bonds are inadmissible assets to the extent that they

are invested in bonds of a face value of not more than $5,000, but funds of a corporation or an association invested in such bonds are admissible assets so far as they are invested in such bonds beyond a principal or face value of $5,000.

Opinion is requested as to whether War Finance Corporation bonds are admissible or inadmissible assets of a corporation, within the meaning of section 325(a) of the Revenue Act of 1918. That subsection includes the provision that—

The term "admissible assets" means * * * bonds and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income * * * The term "admissible assets" means all assets other than inadmissible assets, valued in accordance with the provision of subdivision (a) of section 326, section 330, and section 331.

Therefore, if funds which would otherwise be a part of the invested capital of a corporation are invested in War Finance Corporation bonds, no exclusion of funds so invested from invested capital will be necessary unless interest on such bonds is not included in computing net income. As shown below, the interest on so much of the principal of such bonds as exceeds $5,000 is included in net income, and no funds so invested are to be considered inadmissible assests, by reason of being invested in such bonds, except as are invested in bonds having a face value of $5,000, the interest on which is exempt.

This conclusion has the following basis:

War Finance Corporation bonds, held in excess of $5,000 principal, are subject to surtaxes, although not to normal taxes, under the provisions of section 213(a) (4) Revenue Act of 1918—

In the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under this title and under Title III.

That is, if, under the Acts authorizing the issuing of such bonds, they are not wholly exempt from taxation, such interest may not be excluded from gross income. These bonds are issued under the authority of the Act of April 5, 1918, which provides, in section 16—

That all such bonds shall be exempt, both as to principal and interest, from all taxation now or hereafter imposed by the United States * * * except (a) estate or inheritance taxes and (b) graduated additional income taxes, commonly known as surtaxes, and excess profits and war profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, corporations, or associations. The interest on the amount of such bonds the principal of which does not exceed in the aggregate $5,000, owned by any individual, partnership, corporation, or association shall be exempt from the taxes referred to in clause (b).

Recognizing that a taxpayer may be required to include a certain amount of interest upon such bonds in gross income, section 216(b) of the Revenue Act of 1918 allows a *credit* for—

The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 213.

It is therefore held that interest on an amount of bonds of the War Finance Corporation, the principal of which does not exceed in the aggregate $5,000, is exempt from Federal income and excess profits taxes. Corporate funds invested in such bonds are inadmissible assets to the extent that they are invested in bonds of a face value of not more than $5,000, but funds of a corporation or an association invested in such bonds are admissible assets so far as they are invested in such bonds beyond a principal or face value of $5,000.

Section 325, Article 815: Inadmissible assets. 1–19–118. O. D. 81.

Federal reserve bank stock held by member banks is held to be an inadmissible asset in determining invested capital for excess profits tax purposes.

Section 325, Article 815: Inadmissible assets. 24–19–576. O. D. 305.

Inasmuch as dividends received by a domestic corporation from a foreign corporation deriving income from sources within the United States are allowable deductions in ascertaining the net income of the domestic corporation subject to tax, there could not be included in the invested capital of the domestic corporation receiving the dividends the amount of capital invested in the stock of the foreign corporation, or any part of the value thereof, except as outlined in article 817. (See 5–19–252; sec. 216, art. 301.)

Section 325, Article 815: Inadmissible assets.

(See 22–19–538; sec. 326, art. 838.) Stock of foreign corporations deriving no income from sources within the United States.

Section 325.

(See 11–19–390; sec. 326, art. 831.) Computation of invested capital when no-par-value stock issued for purchase of assets of a going concern, alleged to be worth more than the figures at which the properties in question were entered on the books of the purchaser.

Section 325, Article 818: Admissible assets. 1–19–132. O. D. 93.

Conversion of certificates of indebtedness purchased by a corporation in 1918 into Victory loan notes of same value would not affect invested capital for purposes of war profits tax.

Section 325, Article 818: Admissible assets.

(See 1–19–40; sec 213(b), art. 80.) Amount to be included in admissible assets when Liberty bonds are subscribed for but not fully paid.

Section 326.—INVESTED CAPITAL.

Section 326, Article 831: Meaning of invested capital. 10–19–365.
(Also Section 331, Article 941.) O. 872.

Valuation of Invested Capital in Case of Consolidation Prior to March 3, 1917.

Where two corporations are engaged in different branches of the same business, and the certificate of incorporation of one of them is amended so as to change its name and increase its capital stock, which

new stock is issued in exchange for the stock of the original companies, and this exchange is made prior to March 3, 1917, to determine the invested capital of the new organization there should be added to the invested capital, as defined by Section 207 (a), Revenue Act of 1917, of the company whose certificate has been amended the fair value of the assets of the other company, this latter valuation to be made as of the date of the exchange of stock, and not of a later formal transfer of the tangible assets. (Revenue Act of 1917, secs. 201, 207, and 208.)

Opinion is requested as to the method of determining the amount of the invested capital of the Z Company for the year 1917.

In the year 1916 the M Company and the Y Company were engaged in the manufacture and sale of certain commodities. The M Company had a capitalization of 8x dollars; the Y Company of 5x dollars. It was decided to consolidate the business of the two companies, and to this end the certificate of incorporation of the M Company was in 1916 amended so as to change its name to "Z Company," and to increase its capital stock to 67x dollars. The stock of the Z Company was in that year issued to the stockholders of the M Company and of the Y Company. The assets of the Y Company were formally transferred to the Z Company by a bill of sale and by deed in 1917. A valuation was made in 1916 of the properties of the two companies which indicated that the net assets of the M Company were 12x dollars and of the Y Company 10x dollars. The Z Company seeks to have this valuation of the assets of the two companies, a total of 22x dollars, accepted as the basis of its invested capital for the year 1917.

It is assumed from the statement of facts that there was no change of corporate entity as between the M Company and Z Company, a theory which seems fair to the taxpayer by reason of the statement in the brief presented in its behalf that the certificate of incorporation of the M Company was amended, changing its name to "Z Company," and increasing its capital stock, etc.

The question presented is whether a "reorganization, consolidation, or change of ownership" under these facts was effected before or after March 3, 1917, within the meaning of section 208 of the Revenue Act of 1917; and if before March 3, 1917, how far the valuation of the assets of the two companies made in 1916 may be accepted as the basis of the invested capital of the Z Company for 1917.

The original M Company dealt in raw product, and the Y Company bought and manufactured it. It was, however, decided that the entire business could be better conducted under one management; and with this end in view the M Company increased its capital stock and issued it in exchange for the stock of the other two companies. The result was to vest complete control of the entire business in the Z Company, and to transfer to that company the control of the property of the Y Company as of the time when such merger so became legally effective, which was in 1916.

The Revenue Act of 1917 imposed a tax called the "War excess profits tax" upon "the net income of every corporation, partnership, or individual," in so far as such income exceeded certain percentages "of the invested capital for the taxable year" of the taxpayer (Revenue Act of 1917, sec. 201). "Invested capital" is defined as consisting of (1) actual cash paid in; (2) the cash value of tangible property paid in; and (3) surplus and undivided profits, exclusive of those earned in the taxable year (sec. 207). The statute further provides:

That in case of the reorganization, consolidation, or change of ownership of a trade or business after March 3, 1917, if an interest or control in such trade or business of 50 per cent or more remains in control of the same persons, corporation, associations, partnerships, or any of them, then in ascertaining the invested capital of the trade or business no asset transferred or received from the prior trade or business shall be allowed a greater value than would have been allowed under this title in computing the invested capital of such prior trade or business if such asset had not been so transferred or received, unless such asset was paid for specifically as such, in cash or tangible property, and then not to exceed the actual cash or actual cash value of the tangible property paid therefor at the time of such payment. (Sec. 202.)

The general rule indicated in the statute is that the value of invested capital is to be determined at the time when it is "paid in." It must now be decided when such payment is deemed to be made in cases where there has been a transfer or substitution of stock made in 1916, followed by a formal transfer of tangible assets in 1917.

Restating the rule of section 208, Revenue Act of 1917, for the determination of invested capital:

A. By express provision where there is a reorganization, consolidation, or change of ownership, (1) after March 3, 1917, and (2) 50 per cent or more of an interest or control remains in the same persons, corporations, associations, partnerships, or any of them, then as to assets transferred or received from the prior trade or business, no greater value shall be allowed therefor than if there had been no transfer, *unless* paid for in cash or tangible property.

B. In cases not covered by the provision quoted, that is, cases where the reorganization, consolidation, or change of ownership occurred before March 3, 1917, or after March 3, 1917, with less than 50 per cent remaining in the same control, the invested capital will be determined under the general rule. But where there is no change of identity of the absorbing organization, its prior assets must be valued under section 207 and not at the time of the reorganization, consolidation, or transfer, since there was no transfer of its assets at that time.

Applying the rule to the present case, the mere change of name by amendment with an increase of stock did not involve a change of identity as to the M Company, and there could not have been therefore, a transfer of the assets of that organization within the meaning of the statute. As to the Y Company, there was a transfer of control, and under the facts this transfer was consummated before March 3, 1917, and its assets may therefore be valued as of the time of such transfer.

It will be necessary, therefore, in determining the invested capital of the Z Company to add to the valuation of the assets of the Y Company made in 1916 (assuming such a valuation to have been fair) such a sum as represents the invested capital of the M Company as defined by section 207(a) of the Revenue Act of 1917. The valuation of the assets of the latter company made in 1916 will have to be disregarded, and its assets valued on the basis that no change of ownership or control has occurred as to those assets. There was no transfer or receipt from "a prior trade or business" as to such assets.

Section 326, Article 831: Meaning of invested capital. 11–19–390.
(Also Article 836.) T. B. R. 38.
(Also Section 325.)

Revenue Act of 1917, section 207.—Excess of the value of property (paid in prior to Jan. 1, 1914, for stock or shares having no nominal or par value) over the values recorded on the books.

Neither the statute nor the regulations contains provisions explicitly providing for a case in which the assets and business of a going concern were purchased with stock having no par value and were alleged to be worth more than the figures at which the properties in question were entered on the books of the purchaser. Section 207 of the Revenue Act of 1917 provides for tangible property acquired for stock having a par value and "specifically issued therefor"; and for intangible property purchased for and with shares in the capital stock of a corporation having a par value; and article 59 of Regulations 41 provides for cases where shares of securities having a par value are issued for a mixed aggregate of tangible and intangible property under circumstances where it is possible to produce evidence satisfactory to the Commissioner of Internal Revenue as to the actual values at the date of acquisition of the tangible property. But there is no express provision in the statute or the regulations which provides for a case in which the assets and business of a going concern are turned over en bloc for stock having no nominal or par value.

However, in connection with the determination of invested capital, there is abundant precedent for treating "no-par-value stock" as having a par value equal to its actual value on the date or dates of issue. This rule is adopted in the case of intangible property acquired for no-par-value stock in article 58 of Regulations No. 41; and the same rule has been given general application in the Revenue Act of 1918 (sec. 325 (b)). It would seem therefore entirely in harmony with the letter and spirit of the Revenue Act of 1917, and the regulations issued thereunder to follow the rule that where the assets and business of a going concern have, prior to March 3, 1917, been acquired for stock with no nominal or par value, the properties so acquired may be included in the invested capital at a figure not to exceed their actual cash value at the time acquired (or the actual cash value of the stock or shares paid therefor) care being taken that intangible assets shall not be admitted in an amount exceeding 20 per cent of the total shares of stock outstanding on March 3, 1917, measured by their value as at the date or dates of issue.

Section 326, Article 831: Meaning of invested capital. 11-19-391.
(Also Section 233, Article 542.) T. B. R. 40.
(Also Section 235, Article 581.)

Reasonable commissions or other forms of compensation lawfully paid by a corporation for the sale of its capital stock not to be deducted in computing invested capital.

The opinion of the Advisory Tax Board has been asked as to whether commissions paid by a corporation for the sale of its capital stock are to be deducted in computing invested capital. Upon this question section 326 (a) states that invested capital means (1) "Actual cash bona fide paid in for stock or shares." * * * These words signify the actual cash paid in to the corporation or to its duly authorized agents by the shareholders. Moreover, the treatment of this question and that of the deductibility of such commissions from gross income as ordinary and necessary expenses should be correlative. Under all Federal income tax laws corporations have been denied the right to deduct such commissions either as current expense or as a deferred charge to future years. As it is a fact that such commissions are "ordinarily" paid—and in the organization of many corporations "necessarily" paid—the position of the department with respect to the deductibility from income of this expense can rest only on the ground that it is essentially a capital expenditure, balanced by the acquisition of a permanent capital asset of equivalent worth.

Such payments must, like other compensation for personal service, be "reasonable" in amount. The payment of any unusual or disproportionate commission should, in the opinion of the Advisory Tax Board, be examined for the purpose of ascertaining whether the cash subscription has been "bona fide paid in" and whether under the circumstances of the particular case the commission was reasonable.

Section 326, Article 831: Meaning of invested capital. 11–19–389.
(Also Section 331, Article 941.) T. B. M. 49.

It appears that the Y Company went into the hands of a receiver, the plant being worth, on the basis of cost less depreciation, approximately 8x dollars. The creditors acquired the assets at a receiver's sale at a nominal figure in order to cover loans. They turned the business over to the Z Company, a new corporation formed for the purpose of taking over the property. The conditions of this latter sale were: (1) the Z Company was to supply x dollars working capital; (2) the Z Company was to assume the unpaid liabilities of the Y Company and pay them off within a period of years; (3) the Z Company was to have the assets of the Y Company in return for meeting the liabilities.

Upon these conditions the Z Company was duly incorporated with a capital stock of x dollars subscribed. It is claimed that the stockholders of the new corporation are the same as those of the defunct Y Company, and for that reason the new corporation requests to be permitted to set up an invested capital equal to that of the defunct corporation.

There is a difference of opinion as to whether the x dollars actually paid in to the Z Company in return for their stock should be considered the total invested capital of the new corporation or whether the view should be taken that the new business is substantially a reorganization of the old, and, therefore, the invested capital be fixed upon that basis.

It would appear that the first of these views is correct. The Y Company went into the hands of a receiver and its property was sold to its creditors who were not the stockholders of the corporation. The title to this property passed absolutely to the purchasers, who were in nowise connected with the old corporation, except as creditors. The transaction was closed and completed so far as the old corporation and its stockholders were concerned.

The new corporation which was formed to take over the property could have been incorporated by stockholders of the former company or by entire strangers; the situation so far as it affected the creditors would have been the same. There may have been a community of interest between the stockholders of the old corporation and its creditors, and such interest would be a proving factor in the creation of the new corporation to salvage the property, but this would not change the legal status of the transaction. The new corporation having been formed, it took over the property which had been taken by the creditors in satisfaction of their claims on the following conditions:

They were to furnish x dollars working capital, to raise which they sold stock; and they were to assume the unpaid liabilities of the old corporation in exchange for the property taken over by the banks.

The invested capital of the Z Company, therefore, would appear to be the x dollars received for the stock sold. The value of the property received on condition of the assumption of the unpaid liabilities of the Y Company can not be included in invested capital because it is borrowed capital.

Section 326, Article 831: Meaning of invested capital. 9–19–350.
O. D. 202.

The amount of taxes withheld at the source to be later paid over to the Government is not an asset of the withholding agent and must be eliminated entirely from the computation of invested capital.

Section 326, Article 831: Meaning of invested capital. 13–19–431.
O. D. 248.

Shares of stock distributed by a corporation to its employees in payment of services rendered, where the amount is not excessive, may be included in invested capital to the extent of the actual cash value of the services rendered.

Section 326, Article 831: Meaning of invested capital. 16–19–466.
O. D. 260.

If a bank declares a dividend and pays a certain part to its stockholders and carries the balance to a special account, by whatever name known, e. g., "Stockholders' trustees account," to which account the amounts of speculative loans and investments are charged, such loans and investments and other assets representing the amounts transferred to this account are the property of the individual stockholders, and no portion thereof can be treated as invested capital of the bank.

Section 326, Article 831: Meaning of invested capital. 24–19–577.
O. D. 306.

Where bonds are exchanged for stock in the same corporation under the terms of a convertible trust deed, it will be presumed, for the purpose of computing invested capital, that the value of the bonds is equivalent to the value of the stock. The addition to invested capital would accordingly be the amount for which the bonds were originally sold.

Section 326, Article 831: Meaning of invested capital. 24–19–578.
O. D. 307.

A contract may be treated as tangible property when it relates to rights in tangible property to such an extent that its value arises chiefly therefrom, but it may not be treated as invested capital unless it is bona fide paid in for stock or shares in the corporation, in accordance with section 326 (a) of the Revenue Act of 1918.

Section 326, Article 831: Meaning of invested capital.

(See 13–19–425; sec. 233, art. 541.) Interest on a company's own funds used temporarily for construction purposes charged to capital account.

Section 326, Article 835: Tangible property paid in; mixture of tangible and intangible property. 16–19–467. T. B. R. 49.
(Also Article 868.)

Article 59 of Regulations 41 is a reasonable interpretation of the Act of October 3, 1917, and where a corporation has acquired tangible and intangible property in exchange for its bonds and stocks it will be deemed, in the absence of clear evidence to the contrary, that the intangibles were acquired by the stock.

In computing consolidated invested capital, where one corporation has acquired the stock of one or more subsidiary companies, such transaction should be treated in effect as though the assets of the respective companies had been acquired. In the case under consideration, the decision of the income tax unit in allowing a 9 per cent deduction is approved.

(1) The W Company was formed through the merger of the Y Company and the Z Company with the W Company as it existed before the merger. The new company issued the following securities:

Bonds	67x dollars
Capital stock	59x dollars
Total bonds and stock	126x dollars

The company also assumed liabilities amounting to 9x dollars. For the above securities and the assumption of the liabilities just mentioned the company acquired total tangible assets of 84x dollars and intangible assets of 51x dollars. In computing its invested capital for 1917 the company claims that these securities were issued ratably for both tangible and intangible assets, and that, therefore, 46 per cent of the bonds were issued for tangible and 54 per cent for intangible property. These ratios apply also to the common stock. Is this method of computation correct?

The act of October 3, 1917, provides that, where intangible assets, such as good will, trade-marks, trade brands, etc., have been acquired by capital stock, the maximum amount that may be included in invested capital in respect of such intangibles is limited to 20 per cent of the capital stock of the corporation outstanding on March 3, 1917. This is a purely arbitrary limitation designed to prevent the inclusion in invested capital of excessive amounts of capital stock issued for intangibles in excess of their reasonable value. Where capital stock is issued directly for intangible property, the application of this rule is simple, but where, as in the present case, a mixed aggregate of tangible and intangible property is acquired for the total amount of securities, part of which are in the form of bonds and part of which are in the form of stock, it becomes necessary to determine how much of the tangible property was acquired by bonds and how much, if any, by the issuance of capital stock. Regulations 41, article 59, lays down the rule that—

In the absence of satisfactory evidence to the contrary, it will be presumed in the case of a corporation that its stock was issued for the following purposes in the order named: (*a*) Good will or other intangible property, (*b*) patents and copyrights (*c*) tangible property.

Stating the rule conversely, bonds are to be applied first against tangible property, and any remainder only will be applicable to intangible property. There is no clearly stated rule in the statute; therefore the regulation is based upon inference, and to be sound must be a reasonable interpretation of what the statute requires. In any case in which a mixed aggregate of tangible and intangible property is acquired for a block of securities consisting in part of bonds of the corporation and in part of its capital stock, the allocation of the tangible and intangible property to the respective securities may be made upon one of three possible bases:

(*a*) That the stock was issued first against tangible property, and that the bonds were issued against intangible property;

(*b*) That the bonds and the stock apply ratably against the tangible and intangible assets; and

(*c*) That the bonds apply first against tangible assets, and that the stock was issued against any remaining tangible property and for the intangible property.

Considering briefly these possible bases, the first must be discarded as altogether unreasonable. Corporate securities are not and could not in any ordinary case be issued upon such a basis. The second basis is that claimed by the taxpayer, but it also must be discarded on the ground that it does not conform to the methods of corporate finance. Bonds are universally drawn in such a way as to rank senior to capital stock. A bond aims to give the maximum of security with a moderate rate of return, and this return, while limited in amount, is nevertheless a fixed obligation for the payment of which, together with the principal of the bond, tangible assets are specifically pledged. It is true that in some instances the mortgage or other instrument may cover not only tangible property but intangible property also, but even in such a case the satisfaction of the bond is first sought against the tangible property. The stock as the junior security is more speculative in character. It has no right of foreclosure and after satisfaction of the senior securities the stock must bear all losses. As against this, however, the stock is limited in its return only by the earning capacity of the corporation. Tangible property has an actual value resting upon its permanency and upon the variety of its possible uses. Intangible property is evanescent in its character, and its value rests upon its potential earning power and its use is limited usually to the trade or business in which it has its origin. It thus lacks the elements which make tangible property the accepted security for bonds, but because of its earning power it is a fitting basis for an issue of common stock. These distinctions are not merely theoretical but underlie the whole structure of corporate finance in this country, and are so interwoven with the practice and procedure in the issuance of securities that they have become, for all practical purposes, obligatory.

The rule laid down in article 59 of Regulations 41 is, in the opinion of the Advisory Tax Board, reasonable and fairly interprets the intent of the Statute. It is, therefore, recommended that the claim of the W Company to the right to compute invested capital upon the basis of prorating the bonds and stock issued by it over the tangible and intangible property be denied.

(2) In accordance with a court decree the W Company as it then existed was dissolved. Two new companies, the R Company and S

Company, were organized and a certain portion of the tangible and intangible assets of the W Company was transferred to these new corporations. In this connection the W Company claims that the tangible and intangible property transferred at this time was acquired by it partly for bonds and partly for stock. This question is not material in view of the negative conclusion reached in (1) above. This applies, however, only in so far as it relates to property acquired at the time of the merger and it may be that some part of the intangible property in the form of trade-marks or trade brands so transferred may have been acquired for cash or tangible property since that date. Proper recognition should, of course, be given to the facts in such an event.

(3) The W Company acquired through the merger already mentioned the stock of certain subsidiary companies. In the computation of the consolidated invested capital the Income Tax Unit has treated the acquisition of the stock of these subsidiary companies in the same manner as if the tangible and intangible assets of the respective companies had been acquired. In some cases these subsidiary companies have since been dissolved and upon dissolution the assets have been taken up by the parent company and the liabilities assumed by it. In the opinion of the Advisory Tax Board the method of computation used by the unit as above stated is correct.

(4) The W Company makes claim for prewar deduction of 9 per cent, although its actual earnings during the prewar period amount to less than this percentage of its invested capital. Representative corporations, however, show more than 9 per cent, and the W Company would have shown more than 9 per cent except for a charge that occurred during this period by way of premium paid upon certain bonds of the company which it had called in and canceled pursuant to the dissolution decree.

In view of all these circumstances, the Advisory Tax Board concurs in the decision of the Income Tax Unit that the taxpayer's claim should be allowed.

Section 326, Article 835: Tangible property paid in; mixture of tangible and intangible property. 1–19–120. T. B. M. 5.

Where since the organization of a corporation its capital stock has been increased or reduced and such change represents an actual acquisition of new property for stock or an actual impairment of original properties, the 20 per cent limitation imposed by section 207, Revenue Act of 1917, will be based upon the par value of the total stock outstanding on March 3, 1917. (Also applicable to partnerships.)

Section 326, Article 836: Tangible property paid in; value in excess of par value of stock. 8–19–334. T. B. R. 32.
(Also Section 202, Article 1565.)

How invested capital shall be determined in the case of the X company where bondholders purchased at foreclosure sale the property covered by the mortgage securing the bonds, and then transferred said property to a new corporation in exchange for its total authorized stock issue.

The bondholders of the X company obtained judgment against the debtor corporation in the amount of 4x dollars. The property of the corporation was sold and bid in by the bondholders for 3x dollars. The memorandum states that the cash value of the property was probably less than the judgment and probably more than the bid. After the property was bid in by the bondholders a new corporation with an authorized stock issue of 2x dollars was organized, and the property bid in at foreclosure sale by the bondholders was exchanged for the total issue of the stock of the new corporation. The inquiry is, What shall be the amount of the invested capital of the new corporation?

Article 153 of Regulations 45 provides that where under foreclosure a mortgagee buys in the mortgaged property and credits the indebtedness with the purchase price, the difference between the purchase price and the indebtedness will not be allowable as a deduction for a bad debt, for the property which was security for the debt stands in place of the debt. Article 1563, Regulations 45, also provides that there is no gain or loss arising from the acquisition and subsequent disposition of property when as a result of a transaction there is not a change in substance but merely in form of ownership. It is provided that there must be a change into the equivalent of cash to complete or close a transaction from which income may be realized. These regulations deny to the stockholders the right of taking loss upon the basis of any estimated difference in value between their investment in bonds and the property taken to secure such bonds.

Article 836 provides that evidence offered in support of a claim for a paid-in surplus may consist among other things of an appraisal of the property; certification of the assessed value in the case of real estate; and proof of a market price in excess of the par value of the stock or shares. It provides, however, that "generally, allowable claims under this article will arise out of transactions in which there has been no substantial change of beneficial interest in the property paid in to the corporation, and in all cases the proof of value must be clear and explicit."

In the case of the X Company there has been no change of beneficial interest of the stockholders, and the Advisory Tax Board is of the opinion that the corporation should be allowed to set up an invested capital equal to the value of the property transferred to the corporation as of the date of transfer, such value to be established by evidence acceptable to the Commissioner. The question of gain or loss to the stockholders who were the former bondholders and the invested capital of the new corporation are not concurrent as to time of determination in the above case. The gain or loss of stockholders will be determined on the basis of the price paid for the bonds and the price received for stock of the new corporation when sold.

Section 326, Article 836: Tangible property paid in; value in excess of par value of stock. 14–19–440. T. B. M. 57.

The assets of a corporation can not be valued as of March 1, 1913, for the purpose of computing invested capital.

The X Company has appealed from a decision of the Income Tax Unit that it can not appraise its assets as of March 1, 1913, and use the values thus ascertained as a basis for determining invested capital. The company relies on Lynch *v.* Turrish (247 U. S., 221) and similar decisions, holding that appreciation prior to March 1, 1913, can not be considered net income for the purposes of the income tax.

An inspection of section 207 of the Revenue Act of 1918 with its reiteration of the phrase "value * * * at the time of such payment" clearly shows that with minor exceptions the statutory invested capital is based upon the value of property at the time it is paid in for stock or shares and not upon a valuation at some subsequent date. The law has been consistently interpreted to mean that the basis or starting point in the computation of invested capital is found in the amount of cash or other property paid in, the original values of such other property being determined in accordance with the statute and the regulations. (Art. 42, Regulations 41.) In enacting the Revenue Act of 1918, Congress advisedly continued and confirmed this general principle. (Senate Rept. No. 617, p. 11; sec. 326, Revenue Act of 1918.) This well-established rule must be applied in the present case. The fact that this particular company has defective accounting records and can not accurately compute its invested capital in the ordinary manner may justify assessment under section 210 of the 1917 Revenue Act or section 328 of the 1918 Revenue Act, but does not permit any appraisal of assets at a time subsequent to the date on which they were paid in for stock as a basis of a computation of invested capital.

Section 326, Article 836: Tangible property paid in; value in excess of par value of stock. 1–19–128. O. D. 89.

The value as at January 1, 1914, of tangible property paid in for stock or shares is no factor in computing invested capital under the Revenue Act of 1918.

Section 326, Article 836: Tangible property paid in; value in excess of par value of stock. 1–19–129. O. D. 90.

Paid-in surplus representing tangible property need not be reduced by reason of depreciation of the property in question. All adjustments necessary on account of inadequate or excessive depreciation should be made in connection with earned surplus or undivided profits.

Section 326, Article 836: Tangible property paid in; value in excess of par value of stock. 13–19–432. O. D. 249.

Where a corporation exchanges its stock for the assets of a partnership, which are greatly in excess of the par value of the stock, and there is no written obligation to the partners as to the payment of the excess, the taxpayer is entitled to submit evidence in support of a claim for paid-in surplus; however, if the corporation is obligated to the partners for any portion of the excess, a claim can not be sustained.

Section 326, Article 838: Surplus and undivided profits; earned surplus. 22–19–538. T. B. R. 67.
(Also Section 325, Article 815.)

Revenue Act of 1917.—Treatment, for the purpose of determining the invested capital of a domestic corporation, of shares of stock in a foreign corporation deriving no income from sources within the United States, acquired for cash and in exchange for a patent right.

The M Company, a domestic corporation, organized the O Company, a foreign corporation. The O Corporation issued stock of the par value of 10x dollars to the M Corporation for 5x dollars cash and for the right to use certain patents, which right was worth at least 5x dollars. None of the income of the O Corporation for the year 1917 was derived from sources within the United States. The question is as to the method of treatment of the shares of stock of the O Corporation in determining the invested capital of the M Corporation for the year 1917, under the Revenue Act of that year.

In computing the surplus and undivided profits of the M Corporation, the shares of stock in the O Corporation are to be valued at cost, with proper adjustments, if any. (The method of computing surplus and undivided profits under the Revenue Act of 1918, laid down in article 838 of Regulations 45, is equally applicable to the computation of surplus and undivided profits under the Revenue Act of 1917.) In the cost of the shares of stock of the O Corporation are to be included the cash payment of 5x dollars, and the patent right at its value at the time of the exchange, which value can not be taken as exceeding the value of the shares of stock received in exchange therefor. The effect of the transaction may be to increase or decrease the amount of the surplus and undivided profits of the M Corporation, though the assets which ultimately give value thereto; to wit, the cash and the patent right, remain the same. Such increase or decrease, however, is due to such a change in the situation as amounts to a realization of gain or loss, and any gain so realized is earned surplus, as any loss so realized effects a decrease in earned surplus. (See art. 1565, Regs. 45, as amended by T. D. 2924.) Since earned surplus is considered in determining invested capital regardless of the time when it was earned, it is immaterial that the gain or loss realized from the transaction was due to appreciation or depreciation which in part occurred prior to March 1, 1913. In this respect the principles applicable to the computation of invested capital differ from those applicable to the determination of taxable income for, while such part of the realized appreciation, if any, as is attributable to the period after March 1, 1913, is taxable income, such part as is attributable to the period before March 1, 1913, though considered in the computation of invested capital, escapes taxation.

The shares of stock of the O Corporation constitute "admissible assets" of the M Corporation for the year 1917. The O Corporation derived no income from sources within the United States, and consequently was not subject to income tax under Title I of the Revenue Act of 1916, as amended by the Revenue Act of 1917. (Sec. 10.) The dividends received by the M Corporation upon its stock in the O Corporation should, therefore, be included in the income of the M Corporation for purposes of the excess profits tax. They are not "amounts received * * * as dividends upon the stock * * * of other corporation * * * subject to the tax imposed by Title I of such act of September 8, 1916," within the meaning of section 206 of the Revenue Act of 1917 which authorized the deduction of such amounts from the income of a domestic corporation in order to determine the amount of income of such corporation subject to the excess profits tax. Consequently, the stock of the O Corporation does not constitute "inadmissible assets" under the provision of section 207 of Title II of the Revenue Act of 1917 that—

> As used in this title "invested capital" does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title.

It is held, therefore, that for the purpose of determining the invested capital of the M Corporation (*a*) in computing its surplus and undivided profits its shares of stock in the O Corporation are to be valued at cost with proper adjustments, if any, such cost being $5x$ dollars plus the value at the time of the exchange therefor of the patent rights owned by the M Corporation; and (*b*) such shares of stock are to be regarded as "admissible assets."

Section 326, Article 838: Surplus and undivided profits; earned surplus. 1–19–121. O. D. 82.

Good will created to offset impaired capital has no effect on invested capital. Subsequent earnings must be used first to restore impaired capital; excess may be added to original investment as invested capital.

Section 326, Article 838: Surplus and undivided profits; earned surplus. 1–19–130. O. D. 91.

Any portion of surplus or undivided profits representing unearned interest or discount which has not been reported as taxable income, must be excluded in the computation of invested capital for war profits and excess profits purposes.

Section 326, Article 838: Surplus and undivided profits; earned surplus. 1–19–131. O. D. 92.

If a taxpayer reports profits on installment sales on the basis of the proportionate part of each installment received representing profit, his surplus account as at the beginning of the taxable year must be reduced in computing invested capital to the extent that the surplus account includes profit on such sales which has not been reported as taxable income.

Section 326, Article 840: Surplus and undivided profits; additions to surplus account. 2–19–151. T. B. R. 6.

(1) Where a distilling corporation pursuant to a resolution of the board of directors charged against surplus in 1912 and 1913 amounts aggregating ——— dollars on the ground of alleged obsolescence of a part of its equipment and the entire equipment was continued in use the same as previously, no reduction of output being made and no portion of the property having been retired or scrapped, in fact no change being made beyond the arbitrary reduction of the surplus and invested capital by charging off the ——— dollars on the books of the corporation, it having been shown that these charges were made only for the consideration of the corporation and that they did not enter into the corporation's income tax returns, the amounts so charged off may be restored to invested capital, less proper allowance for ordinary depreciation.

Section 326, Article 840: Surplus and undivided profits; additions to surplus account. 15–19–452. T. B. M. 56.
(Also Section 214, Article 181.)

Amortization allowances deducted in ascertaining net profits for the purpose of the munition manufacturer's tax act (Title III of the Revenue Act of 1916) do not affect "invested capital" under the Revenue Act of 1918.

The munition manufacturer's tax was laid "upon the entire *net profits* actually received or accrued" from the sale or disposition of specific munitions, and it was provided in section 202:

That in computing net profits under the provisions of this title for the purpose of the tax there shall be allowed as deductions from the gross amount received or accrued for the taxable year from the sale or disposition of such articles manufactured within the United States, the following items: * * * (f) A reasonable allowance according to the conditions peculiar to each concern, for amortization of the values of buildings and machinery, account being taken of the exceptional depreciation of special plants.

It is apparent from this language that the amortization allowance in question was authorized for the purpose of computing "net profits," not "net income." The right to make a deduction for amortization in computing net income for the income tax did not exist and was repeatedly denied by the bureau prior to the passage of the Revenue Act of 1918. It is to be noted further that the taxes imposed by Title II of the Revenue Act of 1917 and Title III of the Revenue Act of 1918 were explicitly laid upon "net income," and were in a variety of ways impressed with the stamp and character of an income rather than a munition manufacturer's tax. They are in no sense mere continuations or expansions of the tax imposed by Title III of the Revenue Act of 1916. It follows, therefore, that the deduction for amortization under the munition manufacturer's tax law was not allowed for income tax purposes and should not now be permitted to affect the surplus or any other element entering into the "invested capital" employed for purposes of the war profits and excess profits taxes.

This conclusion is supported by the character of the amortization allowance in question. It was in many respects quite dissimilar from the depreciation and depletion allowances. It was not based upon the fact that plant and equipment acquired in the year 1916 or earlier for the manufacture of munitions, actually depreciated in use or market value during the taxable year 1916. There was in general no such depreciation in value or impairment of useful life. Account was taken "of the exceptional depreciation of special plants" but the principal allowance was "for the amortization of the values of buildings and machinery," whether those values increased or decreased in the immediate future. The principal amortization allowance looked to the establishment of a special fund to recoup exceptional war costs when war uses had ceased; it did not imply that there had been or would be any immediate impairment of physical assets, such as is covered by the depletion allowance, or any immediate exhaustion, wear, tear, or obsolescence in excess of the amount covered by the depreciation allowance. It was, as stated, a special allowance peculiar to this tax, designed possibly to moderate the (then) exceptionally high rates of the munition manufacturer's tax.

Reference has been made in this connection to the wording of section 214 (a) (9) and section 234 (a) (8) authorizing a deduction for amortization under the Revenue Act of 1918; but upon careful examination these paragraphs are found to have no bearing upon the present case.

It is the opinion of the Advisory Tax Board, therefore, that deductions for amortization taken under the munition maunfacturer's tax act do not affect the computation of the invested capital under the Revenue Act of 1918 of the corporations which took such deductions.

Section 326, Article 841: Surplus and undivided profits; limitation of additions to surplus account. 3–19–206. T. B. R. 19.

A corporation acquiring with stock the assets of a previously existing corporation, among which assets are included trade-marks, good will, etc., can not claim as an addition to invested capital amounts expended by the predecessor corporation for the general development of such intangibles and charged by it as current expense.

Section 326, Article 841: Surplus and undivided profits; limitation of additions to surplus account.

(See 8–19–319; sec. 311, art. 781.) Adjustment of salaries paid during prewar period.

Section 326, Article 843: Surplus and undivided profits; patents. 3–19–208. T. B. M. 17.

For the purpose of computing the excess profits tax for 1917 the capital stock paid for patents is not subject to the 20 per cent limitations applicable to good will and certain other forms of intangibles.

Section 326, Article 844: Surplus and undivided profits; reserve for depreciation or depletion. 7–19–308. T. B. M. 41.

The claim of the X Company for the inclusion in its invested capital for the year 1917 of the amount of 6x dollars, representing appreciation in the value of its property, which appreciation had been taken up on its books in 1914 and returned as taxable income for that year, should be denied for the reason that such tax was erroneously assessed and collected. The taxpayer is entitled to a claim for refund.

Reference is made to the claim of the X Company for the inclusion in its invested capital for the year 1917 of an amount of x dollars representing appreciation in the value of a certain part of its property which was taken up on the books in 1914 and returned as a part of its taxable net income for that year, in accordance with article 107 of Regulations 33, which reads as follows:

> ART. 107. It will be noted from these definitions that the gross income embraces not only the operating revenues but also income, gains, or profits from all other sources, such as rentals, royalties, interest, and dividends from stock owned in other corporations, and appreciation in values of assets if taken up on the books of account as gain; also profits made from the sale of assets, investments, etc.

This item was brought to the attention of the Bureau during 1918 and was disallowed in the computation of invested capital for the year 1917. An appeal was made to the Advisory Tax Board, but no evidence has been found that would warrant a change in the original decision of this office.

Regulations 33, from which article 107 is quoted above, were issued in January, 1914, and in March, 1915, the question of the taxability of appreciation of property when taken up on the books of a taxpayer was decided adversely to the Government by the United States Circuit Court of Appeals in the case of the Baldwin Locomotive Works *v.* McCoach, Collector (221 Fed., 59). This decision was embodied in Treasury Decision 2185, issued April, 1915, which held that an "increase in the valuation of assets on the books of the corporation is not income received during the year, where there is no addition to the plant and all that was done was to revalue the property." It appears, therefore, that the return for 1914 was made in accordance with the regulations of the department, but that shortly after the filing of the return the court decision above mentioned made it necessary for the Treasury Department to rescind the provisions of article 107 of Regulations 33, in so far as they related to the taxation of unrealized appreciation. Between April 1, 1915, and the date upon which the tax for 1914 became due and payable a claim might have been filed for abatement of the proportion of the tax represented by the item of appreciation, and since the date of the payment of the tax the company was entitled to file a claim for refund. This right continues for a period of five years from date upon which the return was due.

The computation of invested capital for the year 1917 is to be determined in accordance with the provisions of the Act of October 3, 1917, and Regulations No. 41, issued thereunder. In article 42 of these Regulations it is provided, inter alia, that—

> If value appreciation of a kind not subject to income tax (other than that allowed under article 55) has been taken up on the accounts, a deduction must be made in respect of such appreciation so taken up.

As shown above, the appreciation written up on the books in 1914 was not properly subject to income tax. The exception to this rule as found in article 55 referred to in the quotation above reads as follows:

> Tangible property paid in for stock or shares prior to January 1, 1914, must be valued at either (a) the actual cash value of such property on January 1, 1914, or (b) the par value of the stock or shares specifically issued therefor, whichever is lower.

This regulation is based upon the statutory provision defining invested capital, which is found in section 207(a) (2) of the Act of October 3, 1917:

> The actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January 1, 1914, the actual cash value of such property as of January 1, 1914, but in no case to exceed the par value of the original stock or shares specifically issued therefor).

This provision of the law does not allow for any general appreciation of property as at January 1, 1914, and the inclusion of appreciation in invested capital is limited in effect to cases where capital stock has been issued specifically in payment for tangible assets in an amount which at par exceeded the actual cash value of the property at the date of the transaction, but where between such date and January 1, 1914, the property had appreciated in value. In such a case appreciation in an amount not in excess of the difference between the actual cash value of such property at the date of its acquisition and the par value of the stock issued specifically for the property may be included in invested capital. The case does not come within this exception.

The claim for inclusion in invested capital of x dollars representing appreciation in value of property can not be allowed.

Section 326, Article 845: Surplus and undivided profits; reserve for income and excess profits taxes. 5–19–265. T. B. R. 17.

Treasury Decision 2791 and article 845 of Regulations should not be modified.

Numerous protests against the validity of the principle first adopted in Treasury Decision 2791, approved February 17, 1919, and subsequently embodied in Article 845 of Regulations 45, have been made. A hearing upon the question was held before the Advisory Tax Board at the request of the X Company, at which time its general counsel appeared and argued against the power of the Commissioner to make this regulation, which requires that surplus and undivided profits as of the end of the preceding year must be reduced as of the date or dates when Federal income and excess profits taxes become due and payable, by the amount of such taxes for that year.

In the original and supplemental memoranda filed by the X Company counsel has set forth at length the several arguments of greater or less weight in support of the position urged by that taxpayer.

In the opinion of the board the Commissioner and Secretary in promulgating Treasury Decision 2791 and article 845 have placed the whole matter upon what is the only basis which accords with the requirements of the statute and meets the demands of proper accounting, although it is true that the arguments advanced by counsel for the taxpayer in this case are well presented and at first blush seem convincing and persuasive.

Article 845 of Regulations 45 provides:

For the purpose of computing invested capital, Federal income, and war profits and excess profits taxes are deemed to have been paid out of the net income of the taxable year for which they are levied. It is immaterial, therefore, whether reserves for the payment of such taxes for the preceding year have been set up or not, or if set up whether such taxes when paid have actually been charged against such reserves. Amounts payable on account of such taxes for the preceding year may be included in the computation of invested capital only until such taxes become due and payable. A deduction from the invested capital as of the beginning of the taxable year must therefore be made for such taxes or any instalment thereof, averaged for the proportionate part of the taxable year after the date when the tax or the installment is due and payable.

The provisions of Treasury Decision 2791 relating to the tax under Title II of the Revenue Act of 1917 are substantially the same.

The relevant provisions of the statute are found in section 207 of the Revenue Act of 1917—

As used in this title "invested capital" does not include * * * money or other property borrowed, and means, subject to the above limitations: * * * (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year.

and in section 326 of the Revenue Act of 1918—

SEC. 326. (a) That as used in this title the term "invested capital" for any year means * * * (3) paid-in or earned surplus and undivided profits;

not including surplus and undivided profits earned during the year; * * * but (b) as used in this title the term "invested capital" does not include borrowed capital.

The term "earned surplus and undivided profits" used in both acts is brief but full of import. In effect, it incorporates into the law by reference the entire body of principles of accounting relative to the determination of surplus. There is in neither act any provision defining this term or modifying what must otherwise be accepted as the guiding principle to be applied in determining what is surplus. The statute, therefore, requires that the surplus in any case shall be determined exactly in accordance with the accepted principles of accounting; and it is to those principles that both the taxpayer and the Government must turn for light upon the meaning of this provision of the law.

The application of these principles to the question at issue brings a speedy response and permits of only one answer. A tax levied as these taxes are, for a definite period, must be considered as a liability which has fully accrued at the end of that period; and if not already paid, provision for its payment must be made before there can be any true surplus or undivided profits. This is especially true in the case of an income tax—and excess and war profits taxes are income taxes—which must be considered as a sharing by the Government in the income of the taxpayer for the taxable year. The fact that the tax is in terms of the statute imposed "upon" the net income and that there is no specific provision that it is to be paid "out of" net income can not change its inherent nature.

The amount of these taxes for any year can not, therefore, after the conclusion of such year be considered as a part of the surplus, but is rather in the nature of a liability, and if this regulation is open to criticism at all, such criticism might much more properly be directed against its further provision permitting the amount of such tax to be included as surplus until such time as the tax becomes due and payable.

It is true that in every case the situation is not such that it will be vitally affected by a failure to apply sound principles, and as a result the development of the rulings already referred to as unsound was very easy, but when the situation happens to be such that the effect of the application of a wrong principle would be critical the difference between the sound and the unsound principle is apparent at once. A single example will suffice to illustrate what is meant: Thus, if a business continues to be owned from year to year by substantially the same interests it becomes relatively unimportant whether such taxes are charged against the income upon which they are levied or against other funds; but if the control of that business changes hands and it thus becomes important to charge the taxes against the proper funds, there would never be any question but that they are properly chargeable against the income for which levied. The purchaser would never for a moment admit that they might equally as well be charged against his future earnings or that he should become liable to raise them by borrowing from the bank or otherwise, without allowance being made in the consideration which he pays for the business.

In the opinion of the board the provisions quoted above from section 207 of the Revenue Act of 1917 and from section 326 of the Revenue Act of 1918 are controlling and sustain the interpretation which has been embodied in the form of a regulation in Treasury Decision 2791 and in article 845 of Regulations 45. It is accordingly recommended that no modification in these regulations be made.

Section 326, Article 845: Surplus and undivided profits; reserve for income and excess profits taxes. 12–19–411. T. B. M. 51.

Effect of assessment of additional income and excess profits taxes for prior years upon invested capital.

The rulings contained in Treasury Decision 2791 and article 845 of Regulations 45 require income and excess profits taxes levied for the particular year to be considered as liabilities which have accrued at the end of such year and which must be taken into account in determining the surplus and undivided profits which may thereafter be included in invested capital, and state that such taxes may be included in the surplus until they become due and payable. These rulings are in general applicable to additional assessments.

It is the essence of any system of accrued accounting that items of income and outgo be estimated as they accrue and that the proper entries be made upon the books at that time. The books for any fiscal period are deemed to clearly reflect the history of that period and are not changed even though subsequent events demonstrate that certain accruals, to a minor degree, were incorrectly estimated. The necessary adjustments to correct such errors are made in the current accounts. It is only where major adjustments are necessary that it is good accounting practice to make adjustments for past errors in the surplus account.

For these reasons the Advisory Tax Board recommends that additional assessments of income and excess profits taxes, for prior years which are relatively small or unimportant be considered paid from current earnings; but that where the additional assessment is relatively large and important such assessment be considered a liability of the taxable year in question and that the necessary adjustments of the surplus account be made. In such cases the phrase "due and payable" in article 845, Regulations 45, means the due date for taxes of the taxable year and not the date fixed for the payment of the additional assessment.

It is suggested that in all cases in which the additional assessment is less than 5 per cent of the original assessment or is less than $5,000 it be considered paid out of current earnings and that no adjustment of invested capital be made.

Section 326, Article 845: Surplus and undivided profits; reserve for income and excess profits taxes. 11–19–392. O. D. 222.

The rule expressed in article 845, Regulations 45, that taxes are deemed to be paid out of earnings for the year for which levied, applies to any year of the prewar period as well as to the taxable year. In such cases the amount or amounts payable in a succeeding year on account of such taxes may be included in the computation of invested capital until due and payable.

Section 326, Article 845: Surplus and undivided profits; reserve for income and excess profits taxes.

(See 20–19–506; sec. 214, art. 167.) Reduction of invested capital taken as of the date when tax became due and payable.

Section 326, Article 845 (a): Surplus and undivided profits; reserve for income and excess profits taxes. 23–19–553. T. D. 2931.

Amendment of article 845, Regulations 45.

The final edition of Regulations 45 is amended by inserting immediately after article 845 a paragraph to be known as article 845 (a), as follows:

ART. 845 (a). *Surplus and undivided profits; reserve for 1918 income and excess-profits taxes of corporations having a fiscal year.*—In the case of corporations having a fiscal year, the Federal income and profits taxes for the taxable year 1918 shall, for the purpose of computing invested capital for the taxable year 1919, be deemed to become due and payable as follows: (*a*) As to such amounts as became due and payable prior to February 25, 1919, under the provisions of section 14 (*a*), Revenue Act of 1916, such law shall govern; (*b*) in all other respects the provisions of section 250 of the Revenue Act of 1918 shall govern except that the installments which would become due prior to February 25, 1919, shall be deemed to become due and payable on that date; (*c*) any amounts which became due and payable under said section 14 (*a*) prior to February 25 shall, so far as possible, be deemed to cancel the earlier installments payable under said section 250. For example, a corporation whose fiscal year ended August 31, 1918, is assessed a total income and profits tax under the 1917 law of $250.000 and an additional tax under the 1918 law of $110,000. The total tax of $360,000 would for the purpose of computing invested capital be deemed to become due and payable as follows: February 15, 1919, $250,000; May 15, 1919, $20,000; August 15, 1919, $90,000. If, assuming the same taxes, the fiscal year ended September 30, 1918, the total tax would for the purpose of computing invested capital be deemed to become due and payable as follows: February 25, 1919, $90,000; March 15, 1919, $90,000; June 15, 1919, $90,000; September 15, 1919, $90.000. The provisions of this article apply solely for the purpose of computing invested capital and do not affect the provisions of T. D. 2797 in regard to the time and manner of paying taxes where corporations have filed returns for fiscal years ending in 1918.

Section 326, Article 846: Surplus and undivided profits; insurance on officers. 3–19–209. O. D. 132.

Only the cash surrender value of policies of insurance attributable to premiums paid in prior years which have not been deducted as an expense can be included in surplus.

Section 326, Article 846: Surplus and undivided profits; insurance on officers. 7–19–309. O. D. 179.

The cash surrender value of a life insurance policy which, under article 846 of Regulations 45, constitutes surplus as at the beginning of the taxable year for invested capital purposes, retains its character as surplus even though the policy constituting the admissible asset upon the basis of which the surplus was determined, is terminated and paid.

Section 326, Article 851: Intangible property paid in. 23–19–554. **(Also Section 214, Article 105.)** T. B. M. 81.

The fact that a corporation issues stock as a bonus to its three principal officers to secure their services and participation in the business is not ipso facto sufficient evidence of the existence of good will for which values can be recognized in connection with the computation of invested capital.

Such three principal officers were the principal stockholders and were active salesmen and the only salesmen employed directly by the corporation. Each was allotted certain exclusive territory in which he might employ subagents; all sales made by or through these three principal salesmen constituted the basis on which their commissions or bonuses were calculated. There were certain other sales made directly by the house which were not subject to any bonus or commission deduction. The business of the corporation appeared to be dependent almost solely upon the personal efforts of these three principal officers and stockholders. The rates of commission and the salaries for their services were properly voted.

In this case it was deemed that commission and salary aggregating 50 per cent of the gross margin on the business developed by each was not unreasonable.

Section 326, Article 851: Intangible property paid in. 30–19–644. O. D. 348.

Invested capital on account of intangibles bona fide paid in for stock or shares is limited to 25 per cent of stock with par value plus 25 per cent of the amount fixed in articles authorizing no par value stock as the capital with which the corporation may do business. If the laws of any State authorize issuance of true no par value stock with no amount of fixed capital such no par value stock may be taken into consideration in measuring the value of intangibles, at the fair market value as of the date or dates of issue of such stock or shares.

Section 326, Article 852: Percentage of inadmissible assets. 1–19–125. O. D. 86.

Since the income derived from Porto Rico bonds is not subject to tax, the bonds are inadmissable assets and can not, therefore, be included in invested capital.

Section 326, Article 855: Invested capital for full year or less.

(See 15–19–499; sec. 233, art. 541.) Invested capital of telephone companies for taxable year when operated under Government control.

Section 326, Article 857: Method of determining available net income. 18–19–491. T. B. R. 54.

Memorandum accounts of estimated earnings not considered sufficiently definite to be used instead of the average monthly earnings in computing invested capital under article 857, Regulations 45.

In the case of the M Company three points are presented for consideration and decision: (1) Whether an accrual of taxes for the months of January, February, and March of 1917 is properly used in computing the invested capital for the year 1917; (2) whether, assuming that the bureau was warranted in taking accrued taxes for those months into consideration, was it not in error in using the monthly earnings instead of the average earnings for the year; and

(3) whether any computation can reduce the capital below the actual paid-in capital of the corporation.

The situation presented was brought about in the following manner: The corporation apparently had earnings of 11x dollars for the months of January, February, and March, 1917. During the month of March it declared and paid a dividend of 10x dollars, which amount, taken in connection with the accrual of taxes on the earnings for the first three months of 1917, exceeds the amount of earnings for that period and the balance was construed to have been paid out of accumulated surplus and capital of the corporation at the close of the year 1916. (Incidentally it may be mentioned that the corporation was placed in the position of distributing surplus and capital because at the time of the payment of the dividend there were apparently sufficient earnings to pay the dividend and also to take care of the taxes under the laws then enacted.)

The argument of the corporation relative to the first point is that to use the accrual of taxes in the manner stated is to create a situation in which dividends which were actually paid out of current earnings are made to appear to be practically paid out of surplus and undivided profits, thus working a hardship which the law does not seem to impose. It is presented that the accrued taxes were not paid and were not required to be paid until more than one year after the declaration of the dividend. This point may be disposed of by reference to article 857, Regulations 45, which authorizes the method used for determining the aggregate amount of earnings of the taxable year available for all purposes on any given date. The grounds upon which this article rests have been thoroughly reexamined in connection with this case, and no sufficient reason to change the established ruling has been found.

The other two points are disposed of by the disposition of the second point at issue, as a settlement on the basis recommended will raise the invested capital above the actual paid-in capital and thus dispose of point three.

The second point presented by the corporation is that, assuming that the bureau was warranted in taking accrued taxes into consideration, it was in error in using the monthly earnings instead of the average earnings for the year. Article 857, Regulations 45, provides in substance that average earnings shall be used "unless the corporation shows from its books or other records that a greater proportion of its earnings for the year was available on such date." The agreed statement as to this is that the corporation did not close its books each month, but that it made a fairly accurate memorandum estimate of the earnings of each month for the use of the officers of the corporation. This estimate was not carried into the balance sheet of the corporation, but is asserted to be simply a memorandum for use as above stated. The examining officer, however, accepted this memorandum as a sufficient record of the earnings of the corporation for the three months in question, which estimate was less than the average for those three months would show. But the corporation does not close its books at the end of each month, and the memorandum in question was an informal approximation, insufficient to overthrow the general presumption in favor of the average or prorating method, which in this and many other similar situations under the law has frequently been applied against the desire of the taxpayer. It is recommended, therefore, that the tax liability be computed on the basis of average monthly earnings instead of the figures shown by the memorandum.

Section 326, Article 857: Method of determining available net income. 1-19-124. O. D. 85.

The entire amount of Federal income, war profits, and excess profits taxes accrued for the taxable year remains a part of invested capital for the succeeding year (since it is not deductible from gross income in returns) until the taxes become due in the succeeding year. Accrual of taxes for the taxable year does not affect invested capital for the taxable year, except to the extent that the accrual of such taxes will cause dividend payments to draw on surplus as at the beginning of the year.

Section 326, Article 858: Effect of ordinary dividend. 26-19-598.
(Also Section 201, Article 1542.) O. 942.

The exchange of x shares of common stock for one of preferred stock whereby the capital stock is reduced is a capital transaction and does not result in net income or earned surplus. Whether such a transaction gives rise to a paid-in surplus not decided.

An amount taken from capital or paid-in surplus to meet dividend requirements is deemed a liquidation of capital to that extent and necessitates a reduction in the invested capital. The sum so received by a stockholder is to be regarded as a return of capital so far as it does not exceed the cost of the stock to him, or if acquired prior to March 1, 1913, its fair market value on that date, any excess being taxable as a gain or profit. In case of subsequent payments from capital or liquidation payments upon dissolution, all prior distributions from capital should be considered in determining whether there has been a gain over the cost of the stock or its fair market value as of March 1, 1913.

Dividends paid while there is an operating deficit shall be deemed to be from capital or paid-in surplus, even though there are earnings of the taxable year sufficient to pay the dividend in whole or in part.

The taxpayer, the M Company, is a holding company owning the stock of about y companies. On December 31, 1917, the taxpayer had a surplus. Such surplus was produced in past years largely by the cancellation of common stock in this manner—x shares of common exchanged for one of preferred. An analysis of the surplus account, it is stated, will show that most of the surplus is the result of the exchanges of stock, and if such items were eliminated there would be a deficit.

The questions to be decided are: (1) What is the nature and the result of the transaction by which x shares of common stock were exchanged for one of preferred? (2) What is the effect of payments to stockholders from capital or paid-in surplus? (3) What is the nature and effect of the divident payment in this case? (4) Does the fact that an operating deficit would exist if the items in the surplus account resulting from such exchange of stock were eliminated affect the result in this case? (5) Whether invested capital can be increased by the accumulation of an earned surplus when an operating deficit exists, or whether current earnings must first be applied to repair the deficit?

(1) What is the nature and the result of the transaction by which x shares of common stock were exchanged for one of preferred stock? Such a transaction whereby the capital stock is reduced is a capital transaction and does not give rise to net income or earned surplus. (Article 542, Regulations 45.) Whether such a surrender of stock gives rise to a paid-in surplus or not is a question depending upon facts which are not disclosed by the taxpayer, and no decision is made upon this question. (Article 561, Regulations 45.)

(2) What is the effect of payments to stockholders from capital or paid-in surplus? A distribution of any part of the capital or paid-in surplus is to be regarded as a return to the stockholder of part of the capital represented by his shares of stock. Upon a subsequent sale of such stock, his profit will be the excess of the selling price over the cost to him of such stock or its fair market value as of March 1, 1913, after applying on such cost or value the amount of any such capital distribution. (See article 1549, Regulations 45.) Profits are the only proper source of dividends, and the declaration of dividends when there are no profits is contrary to law. (Conyington, Corporate Organization and Management, p. 399; Thompson on Corporations, art. 5312.) That a surplus such as here considered is capital and not subject to distribution as dividends has been expressly held many times. (See Roberts *v.* Roberts-Wick Co., 184 N. Y. 257, 77 N. E. 13, and cases therein cited.) See also section 201 (a) (1) of the Revenue Act of 1918.

(3) What is the nature and effect of the dividend payment in this case? The dividend paid in February, 1918 (assuming that the taxable year of this corporation is the calendar year), is deemed to have been paid, first, from earnings and profits accumulated since February 28, 1913, and on hand at the beginning of the year; second, if that fund is insufficient, from earnings of the taxable year available on the date that the dividend is paid; third, if those funds are insufficient, from earnings and profits accumulated prior to March 1, 1913; fourth, if those funds are insufficient, from capital or paid-in surplus. (See section 201, Revenue Act of 1918; article 858, Regulations 45.)

In this case there is no earned surplus on hand at the beginning of the year, so that the only question is whether the earnings of the taxable year (class 2) are available for the payment of dividends when there is an operating deficit, or whether such dividends must be deemed to be a distribution of capital. This is not a question which should turn upon the legality of such a dividend in the particular jurisdiction, but is a question depending largely on accounting principles and business practice. From that standpoint there is no doubt but that current profits should be applied to make good the existing deficit before any dividends are distributed. (Dickinson, Accounting, p. 73.) It is the weight of authority in the United States, moreover, that the declaration of a dividend out of current profits, while there is an operating deficit, is contrary to law. (Conyington, Corporate Organization and Management, p. 399.) It is, therefore, held that the dividend in this case was the distribution of capital. It reduces the invested capital and should be treated as a return of capital to the stockholder.

This decision is based on the fact, as stated by the taxpayer, that the M Company is a holding company, owning the stocks of y different corporations. Whether this principle is applicable to a corporation operating a property where the investment of the capital in wasting assets is contemplated, is not decided.

(4) Does the fact that an operating deficit would exist if the items in the surplus account resulting from such cancellation of stock were eliminated affect the result in this case? The Regulations do not require a reduction in invested capital because of an operating deficit. (Article 860, Regulations 45.) They do require, however, a reduction in invested captial where there has been a distribution in liquidation, or a return of capital to the stockholders. The existence of an operating deficit, therefore, does not directly affect the invested capital and is significant in this case only as it throws light upon the sources from which the dividend here in question was paid.

(5) May invested capital be increased by the accumulation of an earned surplus when an operating deficit existed, or must the earnings of the taxable year be applied to repair the deficit? The law defines invested capital as cash or property paid in for stock, earned surplus, and undivided profits and paid-in surplus. The act does not require a reduction of invested capital on account of an operating deficit. It is obvious, however, that no earned surplus can be accumulated until the deficit or impairment of paid-in capital has been made good. (Article 838, Regulations 45.)

It is held, therefore, that the exchange of 4x shares of common stock for 1 of preferred stock whereby the capital stock is reduced is a capital transaction and does not result in net income or earned surplus. Whether such a transaction gives rise to a paid-in surplus not decided.

An amount taken from capital or paid-in surplus to meet dividend requirements is deemed a liquidation of capital to that extent and necessitates a reduction in the invested capital. The sum so received by a stockholder is to be regarded as a return of capital so far as it does not exceed the cost of the stock to him, or if acquired prior to March 1, 1913, its fair market value on that date, any excess being taxable as a gain or profit. In case of subsequent payments from capital or liquidation payments upon dissolution, all prior distributions from capital should be considered in determining whether there has been a gain over the cost of the stock or its fair market value as of March 1, 1913.

Dividends paid while there is an operating deficit shall be deemed to be from capital or paid-in surplus, even though there are earnings of the taxable year sufficient to pay the dividend in whole or in part.

Section 326, Article 859: Effect of stock dividend.

(See 1–19–7; sec. 201, art. 1545.) Effect of stock dividends on invested capital.

Section 326, Article 867: Affiliated corporations; stock of subsidiary acquired for cash. 20–19–518. T. D. 2901.
(Also Article 868.)

Excess profits tax, Revenue Act of 1917; modification of paragraph F, T. D. 2662.

Paragraph F of T. D. 2662, which reads as follows:

Assets of affiliated or subsidiary corporations which have to be adjusted to meet the statutory limitations prescribed by section 207 shall be valued as of conditions existing at the dates when such assets were acquired by the respective affiliated or subsidiary corporations and not as of the date when the stock in such affiliated or subsidiary corporations was acquired by the parent or controlling corporation,

is hereby amended to read as follows:

When all, or substantially all, of the stock of a subsidiary corporation was acquired for cash, the cash so paid shall be the basis to be used in determining the value of the property acquired. Where stock of a subsidiary company was acquired with the stock of the parent company, the amount to be included in the consolidated invested capital in respect of the company acquired shall be computed in the same manner as if the net tangible assets and the intangible assets had been acquired instead of the stock. If in accordance with such acquisition a paid-in surplus is claimed, such claim shall be subject to the provisions of articles 55 and 63 of Regulations 41.

Section 327.—SPECIAL CASES.

Section 327, Article 901: Treatment of special cases. 1–19–119. T. B. M. 7.

The same principle stated in the Revenue Act of 1918 that assessment will not be made as a special case under section 328, when the tax is high "merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital" is applicable to the Revenue Act of 1917 in cases in which application is made for assessment under section 210 of that act.

Section 327, Article 901: Treatment of special cases. 15–19–453. T. B. M. 53.

Recommendation in the case of the application of A. for assessment under section 210. Request denied.

The appeal in this case for assessment under section 210 is based upon the fact that A began to liquidate the business in 1917 and therefore had abnormal profits during that year. This is supported by argument to show that by reason of such liquidation there was a sacrifice of the value of trade brands and other intangibles which should receive consideration.

The record makes it doubtful whether there was any actual liquidation in 1917; but assuming that there was, it had been repeatedly held that a taxpayer who had liquidated all or part of his business in a particular year is not entitled to assessment under section 210, unless such liquidation results in throwing into a single year profits so abnormally high as to result in a tax which, compared with the taxes imposed upon representative business concerns in the same line of business, is seriously disproportionate and productive of exceptional hardship.

A comparison of the return of A with representative concerns in the same line of business discloses the fact that no material change in the tax would result by fixing his tax on the basis of the experience of such representative concerns. It further appears that the amount of the invested capital can be satisfactorily determined without special difficulty, and that under the conditions prevailing in 1917 the profits were not seriously disproportionate to such invested capital. With respect to the alleged liquidation or shrinkage in the value of intangible assets, there were in the year 1917 no facts or events affecting these intangibles sufficiently definite and conclusive to warrant special deductions either as extraordinary depreciation (including obsolescence) or loss. The case plainly does not come within the time limits controlling allowances for the obsolescence of intangible assets in the liquor business, laid down in Advisory Tax Board Recommendation No. 44. The Advisory Tax Board, therefore, recommends that the petition of the taxpayer be denied.

Section 327, Article 901: Treatment of special cases. 14–19–441. T. B. M. 58.

This is an application by the X Company for assessment for the year 1917 under section 209 of the Revenue Act of 1917, or, if this application is denied, for assessment under section 210.

The corporation was engaged in a manufacturing business.

The application for assessment under section 209 should be denied. Under the definition of nominal capital contained in article 74 of Regulations 41 this is not a "case of a trade or business having no invested capital or not more than a nominal capital." (See sec. 209.) It "belongs to a class which necessarily and customarily requires capital for its operation." (See art. 74.)

The application for assessment under section 210 should also be denied. It is true that the excess profits tax rate determined without the benefit of section 210 is very high, approximately 59 per cent, but the profits on the business were clearly war profits, and thus of a kind which were intended to be taxed at a high rate. The case does not come within any of the classes of exceptional cases enumerated in article 52 of Regulations 41 as within the scope of section 210. Obviously it is not within any of these classes unless it is within that:

(4) Where the invested capital is seriously disproportionate to the taxable income.

While the Regulations do not enumerate all the ways in which such cases may arise, this class of cases is limited to cases enumerated or those similar in character. The cases enumerated are those which arise through:

(*a*) The realization in one year of the earnings of capital unproductively invested through a period of years or of the fruits of activities antedating the taxable year; or,

(*b*) Inability to recognize or properly allow for amortization, obsolescence, or exceptional depreciation due to the present war, or to the necessity in connection with the present war of providing plant which will not be wanted for the purposes of the trade or business after the termination of the war.

The present case does not arise in either of these ways, or in any similar manner. Properly speaking, this is a case where taxable income is "high" with respect to invested capital rather than where invested capital is "seriously disproportionate" to such income. Section 210, as interpreted in the Regulations, like paragraph (d) of section 327 of the Revenue Act of 1918, was not intended to afford relief where the only reason therefor is a high rate of tax—that is, a high ratio of taxable income to invested capital. There must be in addition some abnormality with respect to invested capital, taxable income, or both. There is no such abnormality in the present case.

Section 327, Article 901: Treatment of special cases. 15–19–454.
T. B. M. 60.

The limitation of the tax under the Revenue Act of 1918 on profits derived from the sale of a discovered mine can not be applied to the assessment of 1917 taxes, nor can such limitation or any modification thereof be used as a basis for an assessment under section 210 of the Revenue Act of 1917. A case in which income as compared with invested capital has been abnormally increased by the sale of all capital assets, may be considered under section 210, Revenue Act of 1917.

Section 327, Article 901: Treatment of special cases.

(See 19–19–492; sec. 200, art. 1525.) Assessment of a business the volume of which is derived practically from the individual efforts of the stockholders.

Section 328.—COMPUTATION OF TAX IN SPECIAL CASES.

Section 328, Article 912: Determination of first instalment of tax in special cases. 6–19–285.
T. B. M. 30.
(Also Section 335, Article 952.)

The application of section 210 of the Revenue Act of 1917 and sections 327 and 328 of the Revenue Act of 1918 to fiscal year returns.

A corporation having a fiscal year ending June 30, 1918, filed income and excess profits tax returns for that period under the Revenue Act of 1917. Its tax was finally assessed under section 210 of the Revenue Act of 1917. The taxpayer in making its supplemental return for the same fiscal year under the Revenue Act of 1918 wishes to use the same constructive capital as a basis for computing its excess profits tax under the Revenue Act of 1918, and appeals from a decision of the Unit advising it that this can not be done.

Section 335 of the Revenue Act of 1918, which levies the war profits and excess profits taxes for a fiscal year ending in 1918, reads in part as follows:

SEC. 335 (a). That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning in 1917 and ending in 1918, the tax for the first taxable year under this title shall be the sum of: (1) The same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1917 which the portion of such period falling within the calendar year 1917 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates specified in subdivision (*a*) of section 301 which the portion of such period falling within the calendar year 1918 is of the entire period.

In the opinion of the Advisory Tax Board the effect of this section of the statute is that the excess profits tax for a fiscal year ending in 1918 is computed in two ways. First, it is computed as if the entire income had been earned during the calendar year 1917. This involves in some cases an assessment under section 210. Second, it is computed as if the entire net income had been earned during the calendar year 1918. This involves in some cases an assessment under section 328. The proper proportions of the resulting taxes are used to determine the tax for the fiscal year.

Where possible, it would be desirable to consider the application for assessment under section 210 and the application for assessment under section 327 together. Where, as in this case, the assessment under section 210 has already been made, the taxpayer should be notified to file with its supplemental return an application for assessment under section 327. Pending decision upon its application it will be necessary for the taxpayer to compute the additional tax due upon the assumption that the excess profits tax computed under the Revenue Act of 1918 will be not more than 50 per cent of its net income, as is provided in section 328 and article 912–914, Regulations 45. In no case would the constructive capital determined under section 210 be used in making the assessment under section 328.

Section 328, Article 912: Determination of first installment of tax in special cases. 1–19–136. O. D. 94.

Computation of tax on the basis of 50 per cent of the net income under section 328, Revenue Act of 1918, relates only to war excess profits tax. It is not permissible to file bond in lieu of cash payments of tax determined on 50 per cent basis pending final determination of tax due.

Section 328, Article 914: Payment of tax in special cases. 26–19–599. O. D. 321.
(Also Section 250, Article 1001.)

The provisions of section 327 (d) of the Revenue Act of 1918 will not debar a corporation deriving income from Government contracts on the "per unit" basis from filing a claim for assessment under the provisions of section 328. If the claim is filed prior to the due date of the fourth installment of tax and the three installments already paid are equal to the sum of the normal tax plus a war profits and excess profits tax equal to 50 per cent of the net income of the corporation, it will not be necessary to pay the fourth installment, but the additional payments of tax, if any, with interest, may be made when the claim for readjustment of the tax is finally disposed of. The corporation should file a claim for abatement of any taxes assessed in excess of the tax computed.

Section 328, Article 914: Payment of tax in special cases. 31–19–655. O. D. 356.

In cases where application has been made at the time of filing the return for assessment of war profits and excess profits tax in accordance with section 328, Revenue Act of 1918, and the installments of tax determined and assessment made on the basis of 50 per cent of the net income for the taxable year, no abatement claim is required to cover the difference between the tax so computed and the tax computed without the benefit of section 328. If the tax has been computed and assessment made without reference to section 328, and application is made *subsequently* for assessment of the tax in accordance with section 328, payment of the entire tax as originally computed will be required unless a claim is filed for the abatement of the amount assessed in excess of 50 per cent of the net income.

Part VI.—Reorganizations.

Section 330.—REORGANIZATIONS.

Section 330, Article 932: Net income and invested capital of predecessor, partnership, or individual. 1–19–137. T. B. R. No. 2.

The provisions of section 208 of the Revenue Act of 1917 should be applied on the basis of the adjusted balance sheet of the predecessor as of the date of reorganization.

This section reads:

That in case of the reorganization, consolidation, or change of ownership of a trade or business after March 3, 1917, if an interest or control in such trade or business of 50 per centum or more remains in control of the same persons, corporations, associations, partnerships, or any of them, then in ascertaining the invested capital of the trade or business no asset transferred or received from the prior trade or business shall be allowed a greater value than would have been allowed under this title in computing the invested capital of such prior trade or business if such asset had not been so transferred or received.

The question at issue is whether the provision quoted above required the new corporation to base its invested capital on (1) the invested capital of the predecessor as of the beginning of the then taxable year of the predecessor, or (2) on the basis of the balance sheet of the predecessor as of the date of reorganization.

This provision should be held to require the new corporation to base its invested capital on the adjusted balance sheet of its predecessor as of the date of reorganization. The limitation in this section relates in terms to the value which shall be placed upon assets transferred or received from the prior trade or business. Appreciation in the value of assets so transferred or received can not be included in the invested capital of the new corporation. The statute, however, does not prohibit the treatment of the date of reorganization as the beginning of a new taxable year. Consequently it does not require the exclusion from the invested capital of the new corporation of surplus and undivided profits earned between the beginning of the then taxable year of the predecessor corporation and the beginning of the taxable year of the new corporation.

Section 330, Article 933: Election to be taxed as corporation. 6–19–286. T. B. R. 27.
(Also Section 240, Article 632.)

Recommendation in the case of the application of the X Company for permission to incorporate and then make an affiliated return with three corporations owned by the same individuals.

The X Company is a partnership owned by two individuals with equal interests. In 1918 the partnership owned all or more than 99 per cent of the capital stock of three corporations, Y Company, Z Company, and the W Company. The request now before the Bureau is that the partnership should be allowed to incorporate before July 1, 1919, in accordance with section 330, Revenue Act of 1918, and thereafter be allowed to file a consolidated return with the other three corporations which the partnership now owns.

Section 330 of the 1918 Revenue Act provides that:

In the case of the organization as a corporation before July 1, 1919, of any trade or business in which capital is a material income-producing factor and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1918, to the date of such reorganization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1918, * * *: *Provided*, That this paragraph shall not apply to any trade or business the net income of which for the taxable year 1918 was less than 20 per centum of its invested capital for such year: * * *

In the case of the X Company it has been stated that the income of this partnership was more than 20 per cent of its invested capital for the year 1918. Such being the fact, it appears that the law specifically gives to this partnership the right to make return as a corporation for the year 1918 if it shall, before July 1, 1919, organize as a corporation.

While the partnership has a net income of more than 20 per cent of its invested capital, the affiliated group of corporations will have a net income of less than 20 per cent of their invested capital, but this fact does not deprive the partnership of the privilege of incorporating and paying the tax as a corporation for the year 1918.

The partnership upon becoming a corporation in accordance with the provisions of the law, and owning 99 per cent of the capital stock of the other three corporations referred to above, should, in the opinion of the Advisory Tax Board, file a consolidated return.

Section 330, Article 933: Election to be taxed as corporation. 1–19–138. O. D. 95.

Partnership net income as contemplated in section 330, paragraph 3, Revenue Act of 1918, means the net income after deducting salaries of partners.

Section 330, Article 933: Election to be taxed as corporation. 11–19–393. O. D. 223.

A partnership whose net income for the taxable year 1918 was more than 20 per cent of its invested capital may elect to be taxed as a corporation from January 1, 1918, only in case of its reorganization as a corporation before July 1, 1919. There is no authority vested in the Treasury Department to extend the time within which to effect the reorganization.

Section 330, Article 933: Election to be taxed as corporation.

(See 11–19–373; sec. 213(b), art. 79.) Status of corporation on succeeding partnerships in regard to Liberty loan bonds and Victory loan notes originally subscribed for by the partnership.

Section 331.—VALUATION OF ASSETS UPON REORGANIZATION.

Section 331, Article 941: Valuation of asset upon change of ownership.

(See 10–19–365; sec. 326, art. 831.) Valuation of assets where merger takes place prior to March 3, 1917, but formal transfer of tangible assets is subsequent to that date.

Section 331, Article 941: Valuation of asset upon change of ownership.

(See 11–19–389; sec. 326, art. 831.) Determination of invested capital when property purchased at receiver's sale is purchased by creditors and transferred to new corporation.

Part VII.—Miscellaneous.

Section 335.—FISCAL YEARS ENDING IN 1918 OR 1919.

Section 335. 7–19–310.
(Also Section 252, Article 1036.) O. D. 180.

Excess profits tax paid by partnership with respect to income received during 1918 can not be applied as credit to tax due from individual members for taxable year 1918. In such cases claim for refund on Form 46 should be filed by the partnership.

Section 335, Article 952: Fiscal year of corporation ending in 1918.

(See 6–19–285; sec. 328, art. 912.) Application of section 210 of the Revenue Act of 1917 and sections 327 and 328 of the Revenue Act of 1918 to fiscal year returns.

Title XIII.—GENERAL ADMINISTRATIVE PROVISIONS.

Section 1309.—AUTHORITY FOR REGULATIONS.

Section 1309. 15–19–455.
M. 2228.

The Revenue Act of 1918 departs widely at many points from prior law or practice, and has given rise to new questions of such importance, complexity, and number that the resources of the Bureau are no more than adequate to advise taxpayers promptly of their present liabilities arising out of past transactions. It is impossible to answer every question which the invention or ingenuity of the inquirer may devise without neglecting the fundamental duty of determining tax liability upon the basis of actual happenings. Under these circumstances the administrative necessity is obvious of giving precedence over abstract or prospective cases to actual cases in which the taxpayer desires to know what are his immediate liabilities under the law.

It will be the policy of the bureau not to answer any inquiry except under the following circumstances:

(*a*) The transaction must be completed and not merely proposed or planned.

(*b*) The complete facts relating to the transaction, together with abstracts from contracts, or other documents, necessary to present the complete facts, must be given.

(*c*) The names of all of the real parties interested (not "dummies" used in the transaction) must be stated regardless of who presents the question, whether attorney, accountant, tax service, or other representative.

Section 1320.—DEPOSIT OF UNITED STATES BONDS AS SECURITY.

Section 1320. 8–19–336.
O. D. 193.

Where Liberty bonds are deposited as collateral, as provided when a claim for abatement for a loss in inventory is filed (see sec. 214(a), 12, and sec. 234(a), 14), coupons representing one year's interest may be detached from the bonds prior to depositing them as collateral on Form 1124.

Section 1320.

(See 21–19–525; sec. 214, art. 268.) United States bonds deposited as security for claim in abatement.

Title XIV.—GENERAL PROVISIONS.

Section 1400.—REPEAL OF FORMER ACTS.

Section 1400.

(See 12–19–409; sec. 250, art. 1008.) The provisions of Revenue Act of 1916 relating to three-year limitation are continued by section 1400.

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