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JANUARY–JUNE, 1920

INCOME TAX RULINGS

Nos. 656–1033, 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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1920

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 Documents, Government Printing Office, Washington, D. C.

PREFACE.

This Cumulative Bulletin contains rulings and decisions of the Department relating to income and profits taxes, published in the Weekly Bulletins of income tax rulings (1–20 to 26–20) for the period January 1, 1920, to June 30, 1920.

At the upper right-hand corner of each ruling is a key to that ruling, consisting of the bulletin number, the year in which the bulletin was published and the ruling number, separated by dashes. Directly beneath these numbers are letters characterizing the ruling, followed by the number given to it by the Solicitor of Internal Revenue, the Committee on Appeals and Review, or the division of the Income Tax Unit from which it emanated, as the case may be. Thus L. O. 1032 under 23–20–991 indicates Law Opinion 1032 which first appeared in Bulletin 23 of the year 1920, and received the ruling number 991 in that bulletin, it being the 991st ruling published in the Income Tax Bulletin Service.

The following abbreviations are used:

T. D. = Treasury Decision.
Op. A. G. = Opinion of Attorney General.
O. or L. O. = Solicitor's Law Opinion.
S. = Solicitor's Memorandum.
Sol. Op. = Solicitor's Opinion.
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 and when used with the word "dollars" represents a sum of money.

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 bulletin he will find the rulings 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, 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:

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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.

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251. Receipts for taxes.
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254. Returns of payments of dividends.
255. Returns of brokers.
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257. Returns to be public records.
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INCOME TAX RULINGS.

Title I.—GENERAL DEFINITIONS.

SECTION 1.—GENERAL DEFINITIONS.

SECTION 1, ARTICLE 1504: Association distinguished from trust. 9-20-762
S. 1337

The reorganization committee of the M Company is a trust and not a joint-stock association taxable under section 10, Part II, Title I, of the Revenue Act of 1916, as amended by section 1206 of the Revenue Act of 1917.

A question arises on the claim for abatement of corporation income tax for the year 1917 assessed against the reorganization committee of the M Company.

Revenue Act of 1916, Title I, Part II, section 10, as amended, is in part as follows:

That there shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation, joint-stock company or association, or insurance company, organized in the United States, no matter how created or organized, but not including partnerships, a tax of two per centum upon such income; * * *.

The M Company, a corporation, was heavily indebted, and receivers were appointed under court order for the company. The stockholders, bondholders and other creditors of the company hereinafter referred to as "subscribers," entered into an agreement by the terms of which they assigned to trustees, to be known as the reorganization committee of the M Company, all their stocks, bonds, claims, etc., in or against the M Company. By the terms of this agreement the trustees were authorized to organize a new corporation to take over the property and assets of the M Company, and were further authorized to acquire the properties of said company at foreclosure sale or otherwise. They were empowered to pledge or otherwise dispose of the claims and securities transferred to them in order to accomplish this purpose and for the extension and betterment of the properties. The securities of the new corporation, when formed, were to be used to pay the costs of reorganization and improvements and the balance distributed among the subscribers, and a plan of distribution was recommended to the trustees. For this purpose it was agreed that so far as possible the claims and demands should be classified by the court, in order of priority, into three classes. In the reorganization of the old company and the formation of the new the stockholders and bondholders were entitled to vote at all elections on an equal basis; each x dollar face value of such securities entitling the holder to one vote. The trust was to continue for a term of y years unless the reorganization should be sooner consummated and

might be extended by a majority of the subscribers. The trustees were self-perpetuating during the term of the trust and incurred no personal liability except to faithfully carry out the terms of the agreement.

In compliance with this agreement the trustees purchased the property of the M Company from the receivers at a public sale. Title was taken in the name of one of the trustees.

The question now arises whether the reorganization committee of the M Company is liable for corporation income tax under section 10, Part II, Title I, Revenue Act of 1916, as amended.

It is clear that the trustees forming the reorganization committee are not a corporation. Nor are they an insurance company. Therefore it remains to be considered whether they constitute a "joint-stock company or association" within the meaning of the Revenue Act of 1916, as amended.

It seems clear that this committee did not constitute a joint-stock association under any reasonable interpretation of those words. The committee, to be sure, held the stock and bonds of the old corporation and had power to pledge or dispose of them, but merely as trustees and as incidental to the reorganization of the old corporation and the formation of the new. The beneficial interest remained in the subscribers. The committee could not be held to be a joint-stock association within the meaning of the Revenue Act of 1916, as amended, unless all trustees with discretionary powers are such. (*Crocker* v. *Malley*, 247 U. S. 223, 234). Nor can the trustees and subscribers together be regarded as a joint-stock association. The subscribers during the term of the trust had parted with control over the conduct of the reorganization. They had no power to remove or appoint new trustees or to control the actions of the reorganization committee. The provision of the agreement giving the stockholders and bondholders the right to vote at elections in the reorganization of the old company and the formation of the new was intended simply to protect the rights of the bondholders until their debts had been paid by giving them an equal voice with the stockholders in the control and management of the company. This provision was without force or effect during the period of reorganization for the reason that by the receivers sale all the property of the old company passed to the trustees free and clear of any control by the stockholders or bondholders. On the other hand it was provided that when the new corporation was created and the property turned over to it by the trustees the trust should automatically terminate. Thus the right to vote at elections either of the old or the new companies gave the subscribers no control over the committee or the trust property during the period of reorganization. As there was no provision in the agreement for meetings of the subscribers nor any matter on which they could vote excepting that of extending the term of the trust, in case the reorganization was not accomplished within y years, it is apparent that they could exercise no control over the actions of the committee.

It is held, therefore, that the reorganization committee of the M Company is simply a trust and not a joint-stock association.

SECTION 1, ARTICLE 1504: Association distinguished from trust. 9–20–763 O. D. 407

It is the extent of the control vested in beneficiaries under a trust agreement, rather than the extent to which such control is exercised, that is determinative of the question whether the trust is in fact an association within the meaning of the Revenue Act of 1918.

SECTION 1, ARTICLE 1506: Limited partnership as corporation. 15–20–840 O. D. 444

A partnership association or limited partnership organized under sections 8059–8078 of the Ohio Code is an association and not a partnership, within the meaning of section 1 of the Revenue Act of 1918, and is taxable as a corporation.

SECTION 1, ARTICLE 1507: Joint ownership and joint adventure. 12–20–790 O. D. 411

Article 1507, Regulations 45, applies to situations arising under both the Revenue Act of 1917 and the Revenue Act of 1918.

SECTION 1, ARTICLE 1507: Joint ownership and joint adventure. 14–20–820 S. 1361
(Also Section 218, Article 321.)

A and B entered into an agreement, referred to as "articles of partnership," by the terms of which they associated themselves as copartners in business under the name of A & Company and the copartnership was to continue for five years. Prior to this agreement, B had been employed by A in the same business at a salary of x dollars per year. This salary was still paid to B after the partnership agreement was made, but one-fourth of the amount was deducted from his share of the profits. All of the capital was to be contributed by A. The copartnership was to borrow additional capital, if necessary, interest on the same to be paid out of the funds of the copartnership. One-fourth of the profits of the business was to go to B (less $\frac{1}{4}x$ dollars) and the balance to A. Losses in the business were to be borne by the partners in the same ratio as the profits, but in case the losses exceeded the gains the net loss was to be borne wholly by A. In case of the death of either of the copartners the business was to be carried on by the survivor for the benefit of the firm until the close of its current fiscal year, when the partnership affairs were to be settled. In such settlement or at the termination of the copartnership by limitation the entire capital and any increase thereof was to go to A or his executors or administrators. The profits were to be divided and one-fourth (less $\frac{1}{4}x$ dollars) paid to B, his executors or administrators, and the balance to A, his executors or administrators.

A and B contend that the agreement was merely an arrangement for compensation for B, and did not constitute a partnership under the laws of Pennsylvania.

In determining whether or not a particular contract constitutes a partnership, it is necessary to ascertain the intention of the parties as

disclosed by the entire transaction. Particular clauses in the contract, or even express statements, that it does or does not constitute a partnership are not conclusive on the subject. (30 Cyc. 360.) The mere agreement to give to another a part of the profits of the business for his services does not of itself constitute him a partner. (*Ryder* v. *Jacobs*, 169 Pa. 386; 46 Atl. 667.) The sharing of profits, however, is evidence that a partnership exists. In Halstead's Appeal (157 Pa. 59; 27 Atl. 383), a partnership is defined as a relation created by "a contract between two or more persons to place their money, effects, labor, or skill, or some or all of them, in lawful commerce, and divide the profits between them." Exemption from net losses is evidence that the party thus exempted is not an actual partner, but is not conclusive.

In the instant case the parties called their agreement a partnership and evidently so regarded it. They did business under the firm name of A & Company. They shared the profits of the business, and the losses provided they did not exceed the profits. The partnership could borrow money and paid interest on the same from the partnership funds. The salary was borne by both of the copartners. The fact that a special provision was made for the continuance of the partnership in the event of the death of either party shows clearly that they regarded it as a partnership and realized that it would expire on the death of either party in the absence of provisions to the contrary. Everything in the agreement points to its being a partnership, excepting the provision that the net losses should be borne by A alone. In the face of the weight of evidence to the contrary, this one fact is insufficient to show that this agreement was not a partnership.

I am accordingly of opinion that A and B, doing business under the name of A & Company, are a partnership under the laws of Pennsylvania, and liable as such for war excess profits tax for the year 1917.

SECTION 1, ARTICLE 1510: Government contract. 2–20–666 O. D. 359

A corporation which contracted with another corporation to manufacture and deliver machinery to be used in manufacturing ammunition, but did not produce or furnish ammunition or any component part thereof, nor perform any direct service in connection with the production of ammunition manufactured by another corporation under contract for the United States Government, is not a subcontractor within the meaning of section 1, Revenue Act of 1918.

SECTION 1, ARTICLE 1510: Government contract. 5–20–721 O. D. 394

(Also Section 203, Article 1582.)
(Also Section 214(a) 1, Article 101.)
(Also Section 301, Article 715.)

Procurement orders issued after November 11, 1918, in confirmation of informal orders entered into prior to November 12, 1918, are

Government contracts made between April 6, 1917, and November 11, 1918, within the meaning of the Revenue Act of 1918 and whether fulfilled in 1918 or 1919 will be taxed at rates applicable to Government contracts.

In so far as stock purchased for Government contracts is used or useful for commercial purposes no separate inventory thereof need be made for Government contract accounting, such inventories being treated as commercial inventories in the ordinary course at the close of the taxable year 1919. If, however, a portion of such goods purchased is useful only for Government contracts and is still on hand at the close of the taxable year 1919, such goods should be inventoried at the then value if lower than cost and assigned to the Government contract section of the income statement for that year.

Advertising and sales promotion are not a part of the necessary expenses of Government contracts, except as relating to such contracts, and are not proper deductions from the gross income derived from Government sales.

Such expenditures, if entered into on a large scale at a time when the Government was doing practically no commercial business, may be treated either as an expense of the year in which incurred and deducted from the commercial income only, or they may be treated as deferred items in the balance sheet and set up as good will thereon, being in the nature of expenditures for the building up of future business and not for the business secured during the taxable year in which such expenditures were incurred.

SECTION 1, ARTICLE 1510: Government contract. 12–20–791
(Also Section 301, Article 714.) O. D. 412

A contract between the Government and a corporation which was entered into and enforceable against the corporation prior to April 6, 1917, but which was not executed in the form prescribed by section 3744, Revised Statutes, so as to become enforceable against the Government until after that date, is not a "Government contract" within the meaning of that term as defined in the Revenue Act of 1918, and the corporation will not be required to compute its tax upon the profits arising therefrom in accordance with section 301(c) of that Act.

SECTION 1, ARTICLE 1510: Government contract. 17–20–889
O. D. 477

Under the provisions of the Naval Appropriation Acts of March 4, 1917, and July 1, 1918, the President placed with the M Company orders for the construction of certain ships necessary in the prosecution of the war. By the terms of these Acts compliance with all such orders was made obligatory on any person to whom the orders were given. Upon failure to comply therewith the President was authorized to take immediate possession of the factory of such person, allowing such reasonable compensation therefor as should be determined by the President. Contract forms forwarded to the M Company in connection with these orders were modified after dis-

cussion, and as thus modified the orders of the President were accepted and duly executed. The question presented is whether the obligations arising from these orders come within the meaning of the term "Government contract" as defined in the Revenue Act of 1918 and as employed in section 301(c) thereof.

It is the opinion of the Bureau of Internal Revenue that it was unmistakably the intention of Congress that all so-called "order contracts" made by the President under the provisions of the above Acts between April 6, 1917, and November 11, 1918, should come within the meaning of the term "Government contract" as defined in the Revenue Act of 1918. No reason appears why these order contracts should be placed in a different category from other contracts merely because they were given under the authority of a statute providing a penalty for failure to comply therewith. The national emergency existing at the time they were given made it imperative that the work of the Government be given precedence over all other work and begun with the least possible delay. To this end the President by virtue of law issued these orders whereby the work was to begin at once and the terms to be agreed upon at a later date. The terms were to include such reasonable compensation as should be determined by the President. In this connection it is to be noted that the reasonable compensation as finally determined was in reality a result of considerable and lengthy negotiations between the contractors and the Government. The parties concerned were given freedom of agreement and a right to protest against any of the terms that may have been set forth. They were at liberty to sign the contracts as finally drawn or not, as they saw fit. In case the contracts were not signed, a way was left open whereby a different settlement could be reached.

This Bureau is therefore of the opinion and holds that the contracts made on Executive order between April 6, 1917, and November 11, 1918, in accordance with the Naval Appropriation Acts of March 4, 1917, and July 1, 1918, are Government contracts within the meaning of the Revenue Act of 1918, and profits derived therefrom are taxable as provided in section 301(c) of that Act.

SECTION 1, ARTICLE 1510: Government contract. 24–20–993
O. D. 540

The A Company is the selling agent for the entire output of the B mills. On November 6, 1918, the A Company received a telegram from a Government department advising that award had been made to that company to furnish certain goods, and on the same day the A Company advised the B mills of the receipt of this telegram. The A Company on November 25, 1918, subsequent to the signing of the armistice, received the formal contract and immediately placed the order with the B mills. The question arises whether the acceptance of the award on November 6, 1918, constituted a Government contract within the meaning of the Revenue Act of 1918.

The term "contract" has a definite commercial meaning and is broad enough to include any reciprocal promise or engagement whether or not evidenced by a formally executed document. It

may be either oral or written, and a contract entered into with an agent is binding upon the principal.

The fact that a formal contract was executed after November 11, 1918, would not affect the status of the original contract unless such contract was thereby revoked or supplanted, but would be further evidence of the contract and in confirmation of it. The fact that the formally executed contract bore a date subsequent to the date of offer and acceptance, if that be the case, would not change this conclusion.

It is held, therefore, that the acceptance of the award by the A Company as agent for the B mills constituted a Government contract within the meaning of the law, and in preparing its returns the B mills will be required to treat the income therefrom as income derived from a Government contract.

TITLE II.—INCOME TAX.

PART I.—GENERAL PROVISIONS.

SECTION 200.—DEFINITIONS.

SECTION 200, ARTICLE 1523: Personal service corporation. 7-20-736 A. R. R. 24

Held, that M, a corporation conducting a commercial school, is properly classifiable as taxable under section 209 of the Revenue Act of 1917 and as a personal service corporation.

The Committee has had under consideration the appeal of M, a corporation conducting a commercial school. The corporation has both home study and resident instruction departments, but does not lodge or board any of its students.

Education and instruction are primarily and before all personal service and should be so classified unless there are cogent reasons for a different classification. The Unit's action in denying personal service classification appears to have been based upon two grounds: First, that the income is not to be ascribed primarily to the personal activities of the owner, but to the activities of the employees, namely, teachers, solicitors, etc.; and, second, that the business is one which requires the employment of capital in its conduct.

With rare exceptions any corporation or partnership rendering professional services owes the principal part of its net income from such services to the professional ability, reputation, and standing of the principals connected therewith. Thus, clients seek the services of a law firm very largely because of the ability and reputation of the principal members of that firm, although the work in connection with their matters may be handled in detail by salaried subordinates. However, the client knows or feels that in case of difficulty his matters will receive the consideration and scrutiny of the principal members of the firm.

In the case under consideration it is shown that the principal owners give all their time and attention to the preparation of courses, syllabus of work, inspection of higher lessons, and settlement of points in dispute, and it is believed that the fact that there are a number of teachers and clerical employees attached to the corporation is not sufficient in itself to deprive them of section 209 classification.

The question remains, therefore, as to whether capital is a material income-producing factor. The balance sheet of the corporation at the close of 1917 shows only three items on the assets side: Cash, $5x$ dollars; furniture and equipment, $2x$ dollars; and students' acceptances not due or collectible, $33x$ dollars. The latter item is not in reality an asset, but represents merely the tuition fees which matriculating students will eventually pay if they complete the course, and is offset by an item of similar amount on the liabilities side as liability

to students for unearned tuition to be furnished in future period. The total capital used or employed is therefore represented by the capital stock of $7x$ dollars and the surplus and undivided profits of x dollars, offsetting cash, and the furniture and equipment, unless it be construed that the building or office space occupied by the corporation for school purposes, although not owned but rented, is in fact, borrowed capital. The Committee believes that the latter conclusion would be a strained one and would in effect nullify the provisions of section 209, since practically all purely professional concerns must have office accommodations in which to conduct their business, and if the capitalized value of rented space were treated as borrowed capital there would be few, if any, nominal capital concerns. Three x dollars is not an unreasonable amount to be invested in equipment and supplies of a school whose gross income is $60x$ dollars; nor is $5x$ dollars an unreasonable cash balance to carry for the purpose of providing salaries, etc., of necessary teachers and other employees.

Article 72 of Regulations 41 for 1917 expressly provides that—

> Business concerns which render professional or personal service and are of the class normally taxable under article 15 shall not be taken out of that class merely because of the size of the capital if the employment of such capital is necessitated by delay and irregularity in the receipt of fees, etc., or if such capital is wholly or mainly used as a fund from which to advance salaries, wages, etc., or to provide office furniture, accommodations, and equipment * * *.

Capital is a material income-producing factor where profits are made through the active turnover or utilization of such capital in producing income, and it is clear that such is not the case with the corporation under consideration.

For the foregoing reasons the Committee is of the opinion that the corporation in question is entitled to be assessed at the 8 per cent rate under the Act of 1917 and to be classed as a personal service corporation under the Act of 1918, and recommends that the action of the Unit in holding otherwise should be reversed.

SECTION 200, ARTICLE 1523: Personal service corporation. 13–20–802 A. R. R. 46

The Committee has had under consideration the appeal of the M corporation from a ruling of the Internal Revenue Bureau to the effect that the corporation is not a personal service corporation. The ruling in question was made upon a claim for the abatement of capital-stock tax for the taxable period ending June 30, 1919, rejecting the claim.

Section 1000, Revenue Act of 1918, levying a special tax upon corporations, provides (subdivision (c)) that the tax imposed by that section shall not apply to any corporation enumerated in section 231. Among the corporations enumerated in section 231, which is found under Part III of Title II—Income Tax, are personal service corporations. It is proper, therefore, for the Income Tax Unit and this Committee to determine whether or not a corporation is properly classifiable under section 231 as a personal service corporation.

The business of the corporation in question is that of insurance brokers and average adjusters, dealing principally, if not wholly, with questions relating to marine insurance. The corporation was formed by the consolidation of several firms, all of which had been engaged for many years in the business of insurance brokers and average adjusters. Each of the constituent firms liquidated its prior business and contributed to the new corporation only the services of its partners and employees and the good will of its clients. None of these firms contributed any capital or other tangible assets to the new corporation, with the exception of a small amount of office furniture. In order to provide the new corporation with funds for payment of expenses and advances to directors in anticipation of earnings, preferred stock was issued and taken at par by the individual directors, the amount of such preferred stock being $2x$ dollars. In addition to this preferred stock there was outstanding on March 31, 1917, and on March 31, 1918, approximately $3x$ dollars of common stock. This common stock was issued to members of the constituent firms and represented no tangible property and bore no relation whatever to any estimated value of good will, but was merely issued for an arbitrary amount as a basis for the apportionment of future earnings. The articles of incorporation provide that no common stock shall be held by anyone who is not an officer, director, or employee of the corporation and actively engaged in its services. In accordance with this provision, as holders of common stock die or retire from active service, their stock is turned back to the treasury of the corporation, resulting in a decrease in the amount of common stock outstanding. As employees are promoted and made directors, shares of stock are allocated to them by the board of directors in recognition of their services, without other consideration, which results in an increase in the amount of stock outstanding.

Over 95 per cent of the gross income for each of the three fiscal years ended March 31, 1917, 1918, and 1919, was earned from commissions and adjustment fees.

The company's business being principally marine insurance, it has on hand at all times very large cash balances which in fact belong to the insurance companies or clients for whom it acts; thus, its balance sheet at the close of the year, March 31, 1918, shows accounts receivable $6x$ dollars, cash $24x$ dollars, while its accounts payable are $40x$ dollars.

The corporation does not employ a substantial amount of capital to lend to customers, or to buy or carry goods on its own account, or to buy insurance for its clients; nor does it finance or carry the accounts of its clients or customers to any substantial extent.

At the hearing in connection with this case it was stated that all of the directors are daily actively engaged in the business of the corporation, each director for the most part being specially skilled in one or more branches of the business. The business being that of insurance brokerage and average adjustment, the latter a rather intricate branch of marine insurance, the corporation comes squarely within the definition of article 1523, Regulations 45, in that its income, or certainly 95 per cent thereof, "is derived from a profession

or business (a) which consists principally in rendering personal service (b) the earnings of which are to be ascribed primarily to the activities of the principal owners or stockholders, and (c) in which the employment of capital is not necessary or is only incidental." It appears, however, that for various reasons some of the branches of the corporation engaged in the same character of business were separately incorporated, and the profits of these branches appear upon the parent corporation's returns as "dividends received."

Article 1524 of Regulations 45 provides that a corporation can not be regarded as a personal service corporation if another corporation owns or controls substantially all of its stock. This literally construed would prevent the subsidiary corporations from being classed as personal service corporations, and would require their earnings to be taxed at the graduated excess profits rates, although the subsidiaries have little or no invested capital. The reason for the rule laid down in article 1524 where the subsidiary is owned or controlled by a corporation subject to excess profits tax is obvious, but there appears no sound reason in fact where all of the group, parent as well as subsidiary, are engaged in the rendering of personal service, and the corporate entity is merely a legal fiction.

Article 1524 itself and in the same sentence recognizes a distinction when it provides in the second and alternative clause, that a corporation is not a personal service corporation "when substantially all of its stock and of the stock of another corporation (not itself a personal service corporation) * * * is owned or controlled by the same interests," recognizing, inferentially at least, that two personal service corporations may be owned by the same interests, without taking either out of the classification of personal service corporations.

The Committee therefore recommends that the next to the last sentence of article 1524 be amended to read as follows:

A corporation can not be considered a personal service corporation when another corporation (not itself a personal service corporation) owns or controls substantially all of its stock, or when substantially all of its stock and of the stock of another corporation (not itself a personal service corporation) forming part of the same business enterprise is owned or controlled by the same interests—

and that the M corporation be classed as a personal service corporation under the Act of 1918, and that it be taxed at the 8 per cent rate for 1917.

SECTION 200, ARTICLE 1523: Personal service corporation. 20–20–929 A. R. M. 50

REVENUE ACT OF 1917.

Advice has been requested as to the proper classification of the M Company, the company having claimed assessment under section 209 of the Revenue Act of 1917.

It appears that the business of the corporation is that of purchasing agent for certain foreign mining and logging interests. Orders are placed as directed by its clients, and to expedite delivery are placed in its own name. It is further stated that the business of the corporation is such that it is necessary to extend substantial credit

to the firms for which it acts as agent and that to enable the corporation to carry the accounts of its customers, loans have been made during the year aggregating approximately $2x$ dollars. The invested capital of the corporation as computed by the Unit is $2x$ dollars. The balance sheet of the corporation as of December 31, 1916, shows notes and accounts receivable of over $5x$ dollars and acceptances and accounts payable of over $3x$ dollars.

The return as adjusted does not show the gross business of the company, but its gross income on its original return is itemized as being $1\frac{1}{2}x$ dollars from commissions on purchases, dynamite sales, and insurance and $\frac{1}{2}x$ dollars interest charged on open accounts.

Apparently the money borrowed making up the sum total of $2x$ dollars stated above, was utilized for only very short periods as the interest referred to above appears to have been the net amount after deducting from the total receipts interest paid of $\frac{1}{2}x$ dollars.

Article 73, Regulations 41, provides that:

> Agents and brokers requiring and using no capital or merely a nominal capital in their business are taxable under article 15, but commission houses regularly employing a substantial amount of capital, whether to lend to principals or to carry goods on their own account, are not deemed to be agents or brokers and are taxable under the provisions of article 16.

From the foregoing it appears clear that this corporation does regularly employ a substantial amount of capital, while article 1525 of Regulatons 45, whch may be regarded as to some extent declaratory of the intent of Regulations 41, provides that "if the corporation assumes any such risks as those of market fluctuations, bad debts, failure to accept shipments, etc., or if it guarantees the accounts of the purchaser or is in any way responsible to the seller for the payment of the purchase price, the transaction is one of merchandising or trading * * *."

The Committee is therefore of the opinion that this corporation is not taxable under section 209 or classifiable as a personal service corporation under the Act of 1918 unless for the latter year it changed its method of doing business.

SECTION 200, ARTICLE 1523: Personal service corporation. 26-20-1023 A. R. M. 59

> Held, that the decision of the Income Tax Unit denying the application of M & Company for assessment under the provisions of section 209 of the Revenue Act of 1917, was proper and that the corporation is not properly classifiable as a personal service corporation under the provisions of the Revenue Act of 1918.

The Committee is requested to advise whether M & Company should be assessed for 1917 under the provisions of section 209 of the 1917 Act, and classified as a personal service corporation under the provisions of the 1918 Act.

It appears that M & Company was incorporated in 1912 with an authorized capital stock consisting of 250 shares preferred and 300 shares common. This corporation acquired at the time of its organization the good will of the business formerly carried on by a partnership. The capital stock outstanding on December 31, 1917, was 650

shares, of which 550 were common and 100 were preferred, and on December 31, 1918, it had outstanding 550 shares common and 120 shares preferred. A, B, and C own in equal shares the entire outstanding common stock of the corporation. The preferred stock is owned by persons not employed by the corporation.

The corporation filed a return for 1917 and computed its tax under the provisions of sections 201 and 207 of the Revenue Act of 1917. Subsequent to the time of filing of this return the corporation filed an amended return and applied for assessment under the provisions of section 209 of the Act.

It appears that the Tax Reviewers gave considerable consideration to this case before finally passing on it. A number of conferences apparently were granted and the taxpayer was given every opportunity to substantiate the application and claim for assessment under the provisions of section 209.

In view of the fact that this case has received most careful consideration for 1917, the Committee does not feel that the evidence or brief submitted present a different state of facts from those upon which the Reviewers acted. Therefore, it is recommended that the decision conveyed to this corporation in letter dated October 29, 1918, with respect to its 1917 tax liability be confirmed. In this decision the taxability was determined under the provisions of sections 201 and 210 of the Revenue Act of 1917 and articles 18, 24, and 52 of Regulations 41.

It appears that M & Company filed a return for 1918 as a personal service corporation and that the stockholders of the corporation have included in their personal income tax returns their respective distributive shares in the net profits of the corporation for 1918 and paid both the normal and additional taxes on same.

The point at issue for 1918 is whether this corporation is properly classifiable as a personal service corporation within the meaning of that term as used and defined in section 200 of the Revenue Act of 1918.

Section 200 provides that when used in this title—

> The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

The returns filed for 1917 described the business in which the corporation was engaged as engineers, manufacturers' representatives and exporters. For 1918 the business was described in briefs filed on behalf of the taxpayer as sales service, upon a commission basis of compensation, to the various manufacturing concerns which they (M & Company) represent and engineering service rendered to purchasers of the products of the concerns which they (M & Company) represent; their compensation proceeding either indirectly by way of commissions from the vendors or directly from such purchasers.

The facts show that the gross income of M & Company may be segregated into three general classes, as follows:

Class 1.	As agent of certain manufacturers, the corporation sold goods on a commission basis; such goods being billed direct to the vendee by the manufacturer	37%
Class 2.	As agent for foreign purchasers it places orders with manufacturers and is legally responsible to the manufacturer for the purchase price. In such cases the purchaser furnishes an irrevocable letter of credit at a New York bank which can be drawn against on presentation of shipping documents (bills of lading, etc.)	59%
Class 3.	Trading in merchandise for which specific orders from clients have been received, obtaining a profit on the transaction	1%
	Miscellaneous income representing brokerage, discounts earned, interest earned, dividends, etc	3%

From the foregoing classifications of gross income it can readily be determined that there is no question with respect to class one; neither can there by any question with respect to class three. Class two, however, presents a more difficult and technical classification for consideration. Considering this classification from one point of view, the income derived therefrom would be considered income from trading as a principal, inasmuch as the corporation is responsible to the manufacturer for the purchase price. Looking at the situation from another point of view, it appears that the corporation is not trading as a principal even though the accounts are carried through its books, but is trading as agent for an undisclosed principal and using funds advanced by the principal for a specific purpose. In some cases the corporation gets a commission from the seller and also from the undisclosed purchaser.

Article 1523, Regulations 45, provides in part as follows:

> The term "personal service corporation" means a corporation, not expressly excluded, the income of which is derived from a profession or business (*a*) which consists principally of rendering personal service, (*b*) the earnings of which are to be ascribed primarily to the activities of the principal owners or stockholders, and (*c*) in which the employment of capital is not necessary or is only incidental. No definite and conclusive tests can be prescribed by which it can be finally determined in advance of an examination of the corporation's return whether or not it is a personal service corporation.

In Article 1525 it is stated that—

> In order that a corporation may be deemed to be a personal service corporation its earnings must be derived principally from compensation for personal services rendered by the corporation to the person with whom it does business. Merchandising or trading either directly or indirectly in commodities or the services of others is not rendering personal service.

The three principal stockholders own in equal proportion the total outstanding common stock of the corporation, are officers of the corporation, and devote their entire time and attention to the business of the corporation. The preferred stock is owned by persons not employed by nor connected with the operation of the business of the corporation except as stockholders.

The claimant has built up a staff of agents and employees in all parts of the world, most of whom are experts in their own line and many of them are skilled engineers of long experience.

In view of the foregoing it can hardly be said that the income of this corporation can be ascribed primarily to the activities of its principal owners and stockholders, but is rather a combination of the activities of the principal owners and stockholders and the activities of the managers of the various foreign agencies who are not stockholders.

The corporation urges strongly in a brief filed by its attorneys that it is in fact and in law a personal service corporation within the meaning of that term as used in the Revenue Act of 1918. The brief submitted states in detail the reasons why this corporation should be given personal service classification for 1918, irrespective of the ruling of the Tax Reviewers denying such classification for 1917.

The Committee has considered the entire record in this case and particularly the various points raised by the attorneys for this corporation in their brief, and has reached the conclusion that M & Company does not squarely meet all the required tests laid down in article 1523 of the Regulations before personal service classification can be granted. This corporation apparently deals largely in the services of others who are not connected with the corporation through stock ownership but merely as employees. It is reasonable to suppose that the various branch agencies of this corporation contribute materially to the volume of business done and in this way contribute to the net earnings of the corporation. While it is true that neither the law nor the regulations require that the income of the corporation shall be derived solely from the activities of the principal stockholders, the law and regulations do provide certain tests which a corporation must meet before it can be given personal service classification. As to these tests the corporation must meet all of them, not one or two. If the corporation fails to meet all these tests, personal service classification can not be granted.

In view of the fact that this corporation does not squarely meet all the tests prescribed, it is recommended that personal service classification be denied for 1918, and that since abnormal conditions exist which affect the capital of the corporation the tax should be determined and assessed under the provisions of sections 327 and 328 of the Revenue Act of 1918.

SECTION 200, ARTICLE 1524: Personal service corporation; certain corporations excluded.

(See 18–20–904; sec. 325, art. 813.) Application of section 209, Revenue Act of 1917, when income is derived both from commissions and from trading as a principal, and borrowed capital is used.

SECTION 200, ARTICLE 1525: Personal services rendered by personal service corporation. 6–20–724 A. R. R. 23

Held, that the A Company is taxable for the year 1917 under section 201 at the graduated rates and not under section 209 of the Revenue Act of 1917.

The Committee has had under consideration the appeal of the A Company against the ruling of the Income Tax Unit to the effect that the company is liable to excess profits tax for the year 1917 at the

graduated rates, and is not entitled to be regarded as a corporation of nominal capital within the meaning of section 209.

The facts in the case, although not clearly presented by the taxpayer who appears to have misunderstood the significance of some of the questions asked him, appear from his own statements in various letters to be as follows:

The corporation had outstanding at the end of its fiscal year in 1917, preferred stock of x dollars and common stock of $6x$ dollars, all of the latter having been issued against good will. The company appears to have had also an earned surplus of $3x$ dollars, its total adjusted statutory invested capital being $7x$ dollars. The gross income for the year ended in 1917 appears to have been $10x$ dollars and the net income $3\frac{1}{2}x$ dollars. The business is alleged to have been handled on a commission basis. It is stated that for the most part the goods are billed to the A Company and by it rebilled to customers, the amount of the total sales, less A Company's commissions, being remitted to the selling mills. It is evident, however, that a considerable part of the income of the business is derived from what is clearly trading as a principal, it being stated in A's affidavit that $5x$ dollars of the earnings for the fiscal year ended in 1918 was made as a profit on the purchase and sale of certain merchandise.

The balance sheet at the end of the period in question shows accounts receivable of something over $32x$ dollars and merchandise of x dollars, and it is stated that the corporation is liable for any bad debts incurred.

Under the conditions stated it appears clear that the taxpayer has title to the goods sold and is liable to the mills for the selling price although the goods are rebilled, in part at least, at a price which represents merely the addition of commissions in lieu of trading profits.

The Committee is therefore of the opinion that on the facts presented the action of the Unit in denying assessment under section 209 was correct and recommends that that action be affirmed.

SECTION 200, ARTICLE 1525: Personal services rendered by personal service corporation. 17–20–880 A. R. M. 42

REVENUE ACT OF 1917.

A was a consignee agent in the United States for a foreign corporation for a number of years. Later the agency was incorporated in the United States with a nominal capital stock, the shares being at all times owned or controlled by A, who continued in the active management of the agency as before it was incorporated. The income of the agency is commissions only, the foreign corporation merely shipping its product to the agency and paying all charges against the consigned goods. The incorporated agency acts also as selling agent for a domestic corporation, receiving from this source also only commissions on sales. The agency carries no goods on its own account for either of the corporations and does not in any instance acquire title to the products handled. It has never had

any plant, stock of merchandise, nor tangible assets except office equipment.

It does not appear that trading as a principal enters into the transactions in any degree except, perhaps, in one isolated transaction during the war. The agency settles directly with the seller, but it is to be expected that in any agency arrangement all settlements will naturally, if not of necessity, be made through such agency.

The records show that the accounts receivable disclosed by the balance sheet are for the accounts of the consignor firms, and that the accounts payable were due the consignors for amounts collected for their account. The large cash surplus on hand is explained as due to the fact that A himself owns or controls the entire capital stock.

Held, that the incorporated agency is a personal service corporation, having not more than a nominal capital, and that its excess profits tax for 1917 should be determined under section 209 of the Revenue Act of 1917.

SECTION 201.—DIVIDENDS.

SECTION 201, ARTICLE 1542: Presumption as to source of distribution. 2–20–667 O. D. 360

(Also Section 220, Article 351.)

The term "distribution" as used in section 201(b) of the Revenue Act of 1918 means the delivery or transfer of property by a corporation to its stockholders. Whether any distribution by a corporation is to be deemed to have been made from earnings or profits depends upon the facts in each case. However, the term "distribution" as used in section 201(b) of the statute does not contemplate the payments made by a corporation to its stockholders in retiring its own stock if the liquidation of the stock was in pursuance of an obligation arising out of the stock contract, unless it appears that the corporation had the option of distributing its assets with a debit to capital stock account or to surplus account. However, inasmuch as a retirement of capital stock would indicate that additional capital was not required, any retirement of common stock, leaving the surplus stand, would be regarded by this office as making the corporation one coming within the provisions of section 220 of the Revenue Act of 1918.

SECTION 201, ARTICLE 1542: Presumption as to source of distribution. 23–20–992 A. R. R. 127

Held, that the action of the Unit in holding that cash dividends received during the first 60 days of 1918, are taxable at 1918 rates, should be sustained.

The Committee has had under consideration the appeal of A from a holding of the Unit that cash dividends of x dollars received during the first 60 days of 1918 are taxable at 1918 rates.

Section 201(e) holds 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 the preceding taxable years. The law makes no provision, however, anywhere for the taxation of cash dividends, no matter when received, at any rates other than those in force for the taxable year.

That this was intentional is indicated by the provisions of paragraph (d) of the same section, making *stock* dividends received by the taxpayer between certain dates in 1918 subject to tax at the rate prescribed for the years in which the corporation accumulated the earnings so distributed.

It is argued that the language of section 201(e) has no meaning or purpose unless it is intended to subject earnings of prior years, if received during the first 60 days of the taxable year, to the rates of tax during the years in which accumulated. This is not correct. The provision in question has a clear application to the determination of invested capital and was intended to settle the vexed question as to the reduction of invested capital by dividends paid during the early portion of the year when there may or may not have been current earnings sufficient to cover.

The ruling of the Unit is in harmony with the consistent practice of the Bureau, and in the opinion of the Committee, within the clear intention of the law, and it is recommended that the Unit's action be sustained.

SECTION 201, ARTICLE 1544: Dividends paid in property. 17–20–883 O. D. 471

(Also Section 213(a), Article 31.)

A corporation declared a dividend payable in interest-bearing promissory notes. The notes constitute taxable income to the recipients to the extent of their market value at the time of issuance. Subsequent disposition of the notes by sale, or surrender for cash, may result in either a taxable gain or a deductible loss.

SECTION 201, ARTICLE 1547: Sale of stock received as dividend. 18–20–890 O. D. 478

For the purpose of ascertaining the gain or loss arising from the sale of stock received as a dividend or from the sale of stock in respect of which a stock dividend is declared, or both, the "cost" of each share is the quotient of the cost of the old stock (or its fair market value as of March 1, 1913, if acquired prior to that date) divided by the number of the old and new shares added together. (This ruling is in accordance with the principle of the decision of the United States Supreme Court in *Eisner* v. *Macomber*, decided March 8, 1920.)

SECTION 201, ARTICLE 1548: Distribution in liquidation.

(See 16–20–874; sec. 213(a), art. 52.) Computation of profit to stockholders where a corporation in liquidation assigns its assets to trustees who make distributions in installments.

SECTION 201, ARTICLE 1548: Distribution in liquidation. 17-20-877
A. R. R. 67
(Also Section 219, Article 341.)

The Committee has considered the appeal of the executor for the estate of A from a decision of the Income Tax Unit holding that article 1548 of Regulations 45 is applicable in this case and that the estate is liable for tax on the excess of the assets received upon liquidation of the M Company over the indebtedness of the corporation to the estate plus the valuation of the stock owned by A in this corporation at the date of his death.

It appears that A, and subsequently his estate, was at all times the owner of the entire capital stock of the M Company; and that A, the sole stockholder, died during 1918.

In the year 1919 the corporation was dissolved and the estate of A received in payment of loans and surrender of the entire capital stock, the entire assets of the corporation.

The executor for this estate, in appealing from the decision of the Income Tax Unit, relies upon article 1563 of Regulations 45, which provides in part as follows:

> Gain * * * is realized only as the result of a transaction between the owner and another person; also that * * * a change in substance and not merely in form, and, a change into the equivalent of cash are required to close the transaction.

He also refers to article 1566 of Regulations 45, which has been amended by Treasury Decision 2924 and suggests that Treasury Decision 2924 leaves the interpretation as to this particular case somewhat in doubt.

The Committee has considered all the facts presented and has reached the conclusion that this case falls squarely within the provisions of article 1548 of Regulations 45. Any excess in value of the assets received in liquidation of the M Company in cancellation of the total outstanding capital stock and the indebtedness of the corporation to A's estate, constitutes gain and is subject to both normal and additional tax in the hands of the executor.

The article of Regulations 45 referred to above, is based upon that provision of section 201(c) of the Revenue Act of 1918, which reads in part as follows:

> Amounts distributed in 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.

The above quoted provision of law is sustained by the decision of the Supreme Court in the case of *Lynch* v. *Turrish*, from which the following is quoted:

> Where a stockholder in a corporation received as a liquidation dividend, representing his share in the distribution of the proceeds of the sale of the property of the corporation upon dissolution, a sum greater than the cost of his stock, under the Acts of both 1913 and 1916, the gain is income to the stockholder. If, however, he acquired the stock before March 1, 1913, only such portion of the gain as accrued subsequent to February 28, 1913, was taxable under the Act of 1913, or is taxable under the Act of 1916.

Even though the estate of A owned all the capital stock of the M Company, there still existed for tax purposes two entities and the Income Tax Unit is not authorized nor warranted by law or

court decision to look back of the taxable entities. This interpretation was upheld in the Macomber case, recently decided by the Supreme Court.

The Committee therefore recommends that the decision of the Income Tax Unit be sustained.

SECTION 201, ARTICLE 1548: Distribution in liquidation. 17–20–878 A. R. R. 69

The M Company was organized by A and B to take over certain investments owned by them, A holding approximately two-thirds and B one-third of the stock.

Among the assets transferred to this company in exchange for its stock were certain shares in the N Company and the O Company. Subsequently the last named concerns were consolidated into a single corporation and the stock in these companies held by the M Company was exchanged for shares in the new corporation.

Later, A and B decided to liquidate the M Company, and in pursuance of this purpose distributed to the stockholders the assets capable of segregation and distribution. The sole question is whether or not the distribution so made is governed by the decision of the Supreme Court in *Lynch* v. *Turrish* (247 U. S. 221; T. D. 2729) or by the decision of the same court in *Lynch* v. *Hornby* (247 U. S. 339; T. D. 2731).

In the case of *Lynch* v. *Turrish* the court held that a final liquidation dividend including no earnings accrued since March 1, 1913, was not subject to the income tax, while in *Lynch* v. *Hornby* the court held that a dividend distributed by a going concern was subject to income tax irrespective of when the profits distributed were earned. Even if the extreme view of the decision in *Lynch* v. *Turrish*, that a liquidation dividend, whether final or not, was not subject to income tax, be taken it does not appear in this case that the records of the company indicate that there was any formal vote of stockholders declaring their intention to liquidate, and the balance sheets of the company from 1914 to 1918 show the original capital of the company to be unimpaired.

The question of which of the two decisions mentioned governs this case was submitted to the Solicitor, and in an informal memorandum he advised the Income Tax Unit that the only point definitely decided in the case of *Lynch* v. *Turrish* was that a final liquidation dividend which included no earnings accrued since March 1, 1913, was not subject to the income tax, and that under the circumstances the case is controlled by the decision of the Supreme Court in *Lynch* v. *Hornby*, since there is no possibility of making the facts in the case meet the test laid down in *Lynch* v. *Turrish*, the dividend not being claimed to have been a final liquidating dividend and the balance sheets of the M Company from 1914 to 1918 showing the original capital assets of the company to be unimpaired.

While the purpose of the stockholders may have been to liquidate, the Committee is constrained to the view taken by the Solicitor that the facts in the case do not meet the test laid down in the case of *Lynch* v. *Turrish*, and that the dividends distributed were subject to tax.

SECTION 201, ARTICLE 1548: Distribution in liquidation. 18–20–891 O. D. 479

(Also Section 326, Article 862.)

A corporation issued additional shares of stock equal to approximately 7 per cent of the amount previously outstanding, using the proceeds from the sale of the stock to purchase an additional plant which, however, was later abandoned as a manufacturing plant and sold. The proceeds of this sale were used to purchase equipment for carrying out Government contracts during the war. Upon the completion of the contracts the corporation had more funds than were needed in its business and retired approximately twice the amount of additional stock previously issued, paying for each share an amount in excess of its par value. The amount representing the par value of the stock was charged to capital account, and the amount paid in excess of its par value was charged to surplus accumulated prior to March 1, 1913. After the distribution, the corporation had no greater surplus than was reasonably required for the needs of its business.

Held, that the distribution was not a dividend within the meaning of section 201(a) and (b) of the Revenue Act of 1918, but was a distribution in part liquidation of the corporation within the meaning of section 201(c) of the Act.

The transaction should be treated as a voluntary purchase by the corporation of its capital stock for the purpose of its retirement, and the entire cost of such stock is a required deduction from invested capital of the company as of the beginning of the taxable year and effective from the date of purchase only to the extent that such stock has not been purchased out of the undivided profits of the taxable year.

The stockholders who sold their stock to the company should return as income, subject to both the normal and additional taxes, any excess over and above the cost of the stock to them, or its fair market value as of March 1, 1913, if acquired prior thereto.

SECTION 201, ARTICLE 1548: Distribution in liquidation. 19–20–908 O. D. 488

In 1919 a corporation paid three deferred dividends on its outstanding issue of first preferred stock and at the same time redeemed the entire issue of such stock at a premium of 12½ per cent. It is stated that the dividends so paid were those due February 1 and August 1, 1910, and February 1, 1911; that the actual surplus necessary to pay them was accumulated prior to December 31, 1911; that there had not been any actual declaration of these dividends prior to 1919 for the reason that the terms of issue of the stock prescribed when the dividends became due, the company merely having the privilege of deferring payment and that it was the understanding of the officers of the company that its surplus was held to pay past due dividends. The stock certificates contained a provision in accordance with which the deferred dividends were paid and the stock redeemed.

The three deferred dividends will be considered to have been paid out of earnings and profits accumulated since February 28, 1913, as provided for in section 201(a) and (b), Revenue Act of 1918, unless it can be shown that all earnings and profits accumulated since that date were first distributed. If it can not be shown that the earnings and profits accumulated since February 28, 1913, were first distributed, the distribution constitutes income to the recipient stockholders subject to additional tax at the graduated rates, but not to the normal tax.

The payment in redemption of the stock was a distribution in part liquidation of the corporation within the meaning of section 201(c), and not a dividend as defined in section 201(a) of the Act. The amount received by each stockholder in excess of the cost of his shares of stock to him or their fair market value as of March 1, 1913, if acquired prior to that date, represented taxable income to him, subject to both normal and additional tax.

SECTION 202.—BASIS FOR DETERMINING GAIN OR LOSS.

SECTION 202, ARTICLE 1561: Basis for determining gain or loss from sale.

(See 1–20–656; 213(a), art. 33.) Determination of market value of property.

SECTION 202, ARTICLE 1561: Basis for determining gain or loss from sale. 9–20–764 A. R. R. 33

Held, that the figures shown by stock-market quotations on March 1, 1913, determine the value of shares of stock as of that date.

A appealed to the Committee from the action of the Income Tax Unit in assessing a tax on the profit he made in 1916 on the sale of stock of the M Company. The profit was based on the market quotations on the stock as at March 1, 1913.

A contends that the book value of the stock in question on March 1, 1913, was very much in excess of the market quotations and should be utilized as a basis for determining the profit. The Committee is unable to concur in this conclusion.

In Treasury Decision 2979, amending article 102 of Regulations 50, relative to the method of computing the fair average value of the capital stock of insurance companies, the following language is used:

"The fair average value of capital stock for the purpose of determining the amount of the capital stock tax must not be confused with the market value of the shares of stock where it may be necessary to determine such value under other provisions of the revenue laws.

Ample authority can be found to support the distinction between the value of the capital stock or capital assets of a company and the valuation of the shares owned by the shareholders. In the leading case of *People* v. *Coleman* (27 N. E. 818) the court said: "The capital stock of a company is one thing; that of the shareholders is another and a different thing."

The question here at issue is not the value of the capital assets of the M Company but the value of the shares held by A. The Committee is clearly of the opinion that, given a free and broad market, shares of stock in a corporation were worth what they would bring, and that the best evidence of what they would bring is the price they actually did bring when offered for sale and sold upon the stock exchange. M Company stock was freely dealt in before, on and after March 1, 1913, and the quotations as of that date are clearly the best evidence of the value of the shares on that date.

The Committee therefore recommends that the action of the Unit in determining profit on the basis of market quotations instead of book values be sustained.

SECTION 202, ARTICLE 1561: Basis for determining gain or loss from sale. 10–20–777 A. R. M. 34
(Also Section 213(a), Article 41.)
(Also Section 214(a) 8, Article 163.)

Methods of determining value as of March 1, 1913, of intangible assets.

The Committee has considered the question of providing some practical formula for determining value as of March 1, 1913, or of any other date, which might be considered as applying to intangible assets, but finds itself unable to lay down any specific rule of guidance for determining the value of intangibles which would be applicable in all cases and under all circumstances. Where there is no established market to serve as a guide the question of value, even of tangible assets, is one largely of judgment and opinion, and the same thing is even more true of intangible assets such as good will, trade-marks, trade brands, etc. However, there are several methods of reaching a conclusion as to the value of intangibles which the Committee suggests may be utilized broadly in passing upon questions of valuation, not to be regarded as controlling, however, if better evidence is presented in any specific case.

Where deduction is claimed for obsolescence or loss of good will or trade-marks, the burden of proof is primarily upon the taxpayer to show the value of such good will or trade-marks on March 1, 1913. Of course, if good will or trade-marks have been acquired for cash or other valuable considerations subsequent to March 1, 1913, the measure of loss will be determined by the amount of cash or value of other considerations paid therefor, and no deduction will be allowed for the value of good will or trade-marks built up by the taxpayer since March 1, 1913. The following suggestions are made, therefore, merely as suggestions for checks upon the soundness and validity of the taxpayers' claims. No obsolescence or loss with respect to good will should be allowed except in case of actual disposition of the asset or abandonment of the business.

In the first place, it is recognized that in numerous instances it has been the practice of distillers and wholesale liquor dealers to put out under well-known and popular brands only so much goods as could be marketed without affecting the established market price therefor and to sell other goods of the same identical manufacture, age, and character under other brands, or under no brand at all, at figures very

much below those which the well-known brands commanded. In such cases the difference between the price at which whisky was sold under a given brand name and also under another brand name, or under no brand, multiplied by the number of units sold during a given year gives an accurate determination of the amount of profit attributable to that brand during that year, and where this practice is continued for a long enough period to show that this amount was fairly constant and regular and might be expected to yield annually that average profit, by capitalizing this earning at the rate, say, of 20 per cent, the value of the brand is fairly well established.

Another method is to compare the volume of business done under the trade-mark or brand under consideration and profits made, or by the business whose good will is under consideration, with the similar volume of business and profit made in other cases where good will or trade-marks have been actually sold for cash, recognizing as the value of the first the same proportion of the selling price of the second, as the profits of the first attributable to brands or good will, is of the similar profits of the second.

The third method and possibly the one which will most frequently have to be applied as a check in the absence of data necessary for the application of the preceding ones, is to allow out of average earnings over a period of years prior to March 1, 1913, preferably not less than five years, a return of 10 per cent upon the average tangible assets for the period. The surplus earnings will then be the average amount available for return upon the value of the intangible assets, and it is the opinion of the Committee that this return should be capitalized upon the basis of not more than five years' purchase—that is to say, five times the amount available as return from intangibles should be the value of the intangibles.

In view of the hazards of the business, the changes in popular tastes, and the difficulties in preventing imitation or counterfeiting of popular brands affecting the sales of the genuine goods, the Committee is of the opinion that the figure given of 20 per cent return on intangibles is not unreasonable, and it recommends that no higher figure than that be attached in any case to intangibles without a very clear and adequate showing that the value of the intangibles was in fact greater than would be reached by applying this formula.

The foregoing is intended to apply particularly to businesses put out of existence by the prohibition law, but will be equally applicable so far as the third formula is concerned, to other businesses of a more or less hazardous nature. In the case, however, of valuation of good will of a business which consists of the manufacture or sale of standard articles of every-day necessity not subject to violent fluctuations and where the hazard is not so great, the Committee is of the opinion that the figure for determination of the return on tangible assets might be reduced from 10 to 8 or 9 per cent, and that the percentage for capitalization of the return upon intangibles might be reduced from 20 to 15 per cent.

In any or all of the cases the effort should be to determine what net earnings a purchaser of a business on March 1, 1913, might reasonably have expected to receive from it, and therefore a representative period should be used for averaging actual earnings, eliminating any

year in which there were extraordinary factors affecting earnings either way. Also, in the case of the sale of good will of a going business the percentage rate of capitalization of earnings applicable to good will shown by the amount actually paid for the business should be used as a check against the determination of good will value as of March 1, 1913, and if the good will is sold upon the basis of capitalization of earnings less than the figures above indicated as the ones ordinarily to be adopted, the same percentage should be used in figuring value as of March 1, 1913.

SECTION 202, ARTICLE 1561: Basis for determining gain or loss from sale. 13–20–803 O. D. 418

The stockholders of one of several banks which were consolidated received in exchange for their shares of stock, stock of the consolidated bank of no greater aggregate par value than their shares in the old bank. Bonds purchased by the old bank subsequent to March 1, 1913, at 80 were taken over by the consolidated bank at 70 and later sold by it at 80. Held under the circumstances that there was for income tax purposes, no realization of gain or loss at the time of consolidation to either the old bank or its stockholders, neither did the consolidated bank realize any profit on the sale of the bonds, since it should have taken up the bonds on its books at the same figure at which they were carried by the old bank.

SECTION 202, ARTICLE 1561: Basis for determining gain or loss from sale.

(See 17–20–887; sec. 233, art. 544.) Gain or loss on sale of bonds purchased at a premium or a discount.

SECTION 202, ARTICLE 1562: Sale of property acquired by gift or bequest. 5–20–712 O. D. 386

The basis for determining gain or loss from the sale of a homestead acquired from the Government will be the fair market value of the homestead at the date of its acquisition or the value at March 1, 1913, if acquired prior to that date.

The date of acquisition of a homestead acquired by public grant is the date of entry upon the land. The taxpayer will not be entitled to add to the value of the homestead the amount expended for relinquishment in order to clear the Land Office records, nor any fees paid to the Government, but the cost of improvements may be added to the value as of the date of acquisition.

SECTION 202, ARTICLE 1562: Sale of property acquired by gift or bequest. (Also Section 219, Article 342.) 12-26-792 O. 1012

INCOME TAX: REVENUE ACT OF 1918, SECTIONS 219, 213, 202.

Income of Trusts—Gain from Sale of Capital Assets.

In computing the gain or loss from the sale of stock by the trustees under the will of A, the value of the stock sold at the date of the death of A should be used as a starting point, rather than the value of such stock at the date of distribution to the trustees. Article 1562, Regulations 45.

The gain, if any, from the sale of stock by the trustees is taxable income which must be reported for taxation by the trustees and the income tax upon which must be paid by the trustees. The fact that the remaindermen who will in the future, subject to certain contingencies, receive this income, are exempt corporations, does not alter this conclusion.

Consideration is asked of the taxability of certain income received by trustees under the will of A. By the terms of the will the residue of A's estate is bequeathed to his executors and trustees in trust "to hold the same during the life of my said wife, B, with full power to sell and reinvest the same, or any part thereof, as they may deem expedient, and to pay the income thereof to my said wife in quarterly payments as said income shall accrue." Upon the death of the wife the residue of the estate then remaining is to be paid by the trustees to certain specified corporations organized exclusively for charitable purposes. If the income was not sufficient to provide for the proper maintenance of the wife, the trustees might pay to her from the principal such sums as might be necessary. The residue of the estate consists principally of corporate stocks which are now held by the executors. Such stocks have appreciated in value since the death of the testator. It is proposed to transfer the stock from the executors to the trustees, who will immediately sell the same. The taxpayer states that the proceeds from the sale of the stock by the trustees must be added to the corpus or principal of the trust.

Two questions are involved: First, whether in determining gain or loss from the sale of such stock the trustees should use as a basis the value of the stock on the date of the testator's death or the value of the stock on the date when such stock is transferred by the executors to the trustees; second, assuming that there is a taxable gain from such transfer, whether the taxability is affected by the fact that such gain is not distributed to the life tenant, but is accumulated for the benefit of the remaindermen, and that such remaindermen are corporations exempt from income tax.

Section 213(b) of the Revenue Act of 1918 provides that the term gross income—

(b) Does not include the following items, which shall be exempt from taxation under this title: * * * (3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income).

Section 202 (a) 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; or the inventory value, if the inventory is made in accordance with section 203.

Section 219 (a) of the Revenue Act of 1918, provides:

That the tax imposed by sections 210 and 211 shall apply to the income of estates or any kind of property held in trust including * * * (3) income held for future distribution under the terms of the will or trust; and (4) income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals * * *.

Section 219 (b):

* * * The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that there shall also be allowed as a deduction * * * any part of the gross income which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid to or permanently set aside for * * * any corporation 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.

I. In determining gain or loss from the sale of such stock should the trustees use as a basis the value of the stock on the date of the testator's death, or the value of the stock on the date when such stock is transferred by the executors to the trustees?

The taxpayer contends that the trustees in accounting to the probate court will be charged with the value of the stock on the date it is transferred to them; that they are in no sense responsible for and have no control over the acts of the executor; and that they can not be held responsible for appreciation in value accruing prior to the time they are in actual control of the property in question. This question has been answered contrary to the contention of the taxpayer by article 1562 of Regulations 45, and by Law Opinion 624.

It is true that at common law and under the statutes in most of the States the title to personal property of a deceased person vests in the administrator, if there is one, and not in the heirs or distributees. however, persons entitled to personal property as heirs or distributees acquire a vested equitable right immediately on the death of the intestate and on distribution their title relates back to the intestate's death. (18 Corpus Juris, 878; *Lewis* v. *Sedgwick* (Ill. 1906), 79 N. E. 14.) That is, a distributee's interest in the estate of an intestate accrues by operation of law immediately upon the death of the intestate, and the subsequent distribution merely serves to ascertain and define and convert into a legal right, and reduce to possession an equity which existed before in the form of a chose in action, cognizable in chancery. (*Perryman* v. *Greer*, 39 Ala. 133.) Most of these cases arise where there are no debts and no administrator is appointed, and the distributees settle the estate without judicial intervention. Such cases often state generally "the equitable title to the personal property after his death was at all times in the heirs who owned it subject to the right of creditors and the expenses of administration." (*Power* v. *Pennock* (Mich. 1914), 148 N. W. 430; *Brown* v. *Baxter* (Kans. 1908), 94 Pac. 155; *Moore* v. *Brandenburg* (Ill. 1911), 92 N. E. 733; *Schoenwetter* v. *Schoenwetter* (Wis. 1916), 159 N. W. 737.) The same rule applies to a specific bequest of stock where the other personal property was sufficient to pay the debts. It was held the title to such stock vested in the legatees. (*Cabble* v.

Cabble, 97 N. Y. Sup. 773.) The conclusion that the next of kin or legatee gets a vested equitable right at the time of the testator's death is strengthened by the fact that all rights in such estates are determined as of the date of the death of the decedent. For example, the personal estate of an intestate goes ultimately to those who are his next of kin at the time of distribution. (*Thompson* v. *Thomas*, 30 Miss. 152.) Where a person entitled as distributee dies after the death of the intestate and before the distribution, his share does not go to the other person or persons entitled as distributees, but vests in the personal representative of the deceased distributee for distribution to the persons entitled to his property. (18 C. J. 879.)

These legal principles strengthen and confirm the holding of Law Opinion 624 and article 1562 of Regulations 45, namely, that the basis for measuring loss or gain from the sale or other disposition of property acquired by bequest, devise, or descent, is the value of such property at the date of the decedent's death, whether decedent dies testate or intestate, and whether the bequest or devise be specific or residuary. The value of the gift exempted by section 213(b) is the value at the time of the gift, viz, the date of the donor's death. No subsequent accretions to that value realized by sale can be claimed as exempt by the donee. The date when such property is beneficially "acquired" is the date of the death of the testator and section 202 by analogy requires the valuation on the date of acquisition to be used as the starting point. It is therefore held that in computing gain or loss from the sale of stock by the trustees under the will of A the value of such stock at the date of the death of A should be used as a starting point. The value of such stock as appraised for the purpose of the Federal estate tax, or in the case of estates not subject to that tax, its value as appraised in the State courts for the purpose of State inheritance taxes shall be deemed to be its fair market value at the date of the death of the testator.

II. Assuming that there is a gain from such transfer, is the taxability affected by the fact that such gain is not distributable to the life tenant, but is held for the benefit of the remaindermen, and that such remaindermen are corporations exempted from income tax.

It is stated by the taxpayer that the profit from the sale of this stock can not be distributed to the widow who is entitled to the income for her life, but must be added to the corpus and distributed to the remaindermen upon her death. Such is the rule for the distribution of such moneys in Massachusetts. (*Trefry* v. *Putnam* (Mass. 1917), 116 N. E. 904.) Although for the purpose of division between the life tenant and the remaindermen of the property the probate courts hold that such a gain is not income distributable to the life tenant, there is no question but that the Revenue Act of 1918 classes such gains as taxable income which must be accounted for if received by an entity subject to tax (sec. 202) and that in administering an income tax the distinctions made by probate courts between capital and income in any other branch of the law need not necessarily be followed. This particular rule is not followed by Massachusetts in administering the Massachusetts income tax law. (*Trefry* v. *Putnam* (Mass. 1917), 116 N. E. 904.)

It is objected, however, that the life tenant has no beneficial interest in such gain and that it would be highly unjust to assess the tax

upon such gain to the life tenant. This argument is of great force if the burden of the tax is to fall on the income distributed to the life tenant. It is believed, however, that this trust is of a mixed character that its ordinary income is "income which is to be distributed to the beneficiaries periodically" and which should be reported by the widow in her individual income tax return as her distributive share of the net income of the estate or trust for the taxable year in accordance with subdivision (d) of section 219; that the income derived from the gain on the sale of the capital assets is "income held for future distribution under the terms of the will or trust" the tax upon which should be paid by the fiduciary in accordance with subdivision (c) of section 219. Section 219 does not require that all of the income of a particular estate or trust shall fall within one of the four classes specified. For example, where there has been a partial distribution, some of the income may be received under class (1) and the balance under some one of the other classes. So it is not only possible, but probable, that in many cases a certain part of the income, or income of a certain character, will be distributed periodically while another part of the income will be held for future distribution or accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interest. Such a situation is expressly provided for in subdivision (c) of section 219. If because of this mixed character part of the income is to be reported and tax paid by the trustee the mixed character of the trust must be recognized and a mixed report of the kind suggested in this case must be made. Such a situation has been recognized under the Revenue Act of 1916. Law Opinion 599.

It is further contended as to the income held for future distribution under the terms of the will that no tax should be collected upon such income because the ultimate beneficiaries are corporations organized and operated exclusively for charitable purposes. Reliance is also placed upon subdivision (b) of section 219, providing for the deduction of sums "permanently set aside" for such corporations. However, the statute levies the tax as to such income upon the fiduciary for the taxable year when such income is received. The fact that at some uncertain date in the future the corpus of the estate, including the accumulations of income of a certain character, will, if it is then in existence, be paid over to exempt corporations does not relieve the trustees from the obligation of paying the tax. The statute imposes the tax upon all trust estates. No express exemption of trustees who are to hold income for future distribution to exempt corporations appears in the statute, and the Commissioner has ruled that no such exemption exists. (Solicitor's Memorandum 451, article 342, Regulations 45.) Such a ruling does not amount to the taxation of corporations exempt under section 231 of the Revenue Act of 1918. The connection between the present income of the trustees and the future rights of the exempt corporation is too remote to make the tax in substance one upon the exempt corporation. The case of *Stockton* v. *Lederer*, decided by the District Court for the Eastern District of Pennsylvania under the earlier Revenue Acts, is opposed to this reasoning. That decision has not been acquiesced in by the Government, arose under a different statute, and may have turned upon particular facts. The language of the Revenue Act of

1918 is so specific in treating a trust estate as a taxable entity that the reasoning of that decision is inapplicable.

Nor can it be said that the income accumulated for future distribution is permanently set aside for the remaindermen. The will specifically provides that the trustees may in their discretion pay to the widow from the principal such sums as may be necessary to provide for her proper maintenance. The existence of this contingency, which may divert the corpus and accumulated income to the widow, requires the decision that such sums are not permanently set aside for the remaindermen. Compare Solicitor's Memorandum 1135 and In re Howland's estate, 178 N. Y. 368.

It is therefore held that the gain, if any, from the sale of stock by the trustees is taxable income which must be reported for taxation by the trustees and the income tax upon which must be paid by the trustees. The fact that the remaindermen who will in the future, subject to certain contingencies, receive this income are exempt corporations does not alter this conclusion.

SECTION 202, ARTICLE 1563: Exchanges of property. 7–20–737 T. D. 2971

Regulations 45 are hereby amended by substituting for article 1563 as it now stands the following:

ART. 1563. *Exchanges of property.*—Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized. By way of illustration, if a man owning ten shares of listed stock exchanges his stock certificate for a voting trust certificate, no income is realized, because the conversion is merely in form; or if he exchanges his stock for stock in a small, closely held corporation, no income is realized if the new stock has no market value, although the conversion is more than formal; but if he exchanges his stock for a Liberty bond, income may be realized, because the conversion is into independent property having a market value. "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. 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. It does not follow 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 property received in exchange may be real estate, personal property, or a chose in action. Where the owner of a bond exercises the right, provided for in the bond, of converting the bond into stock in the obligor corporation, such transaction does not result in a realization of profit or loss, the transaction not being closed for purposes of income taxation until such stock is sold.

SECTION 202, ARTICLE 1563: Exchanges of property. 14–20–821 O. D. 429

Under the provisions of section 202 of the statute, and in accordance with article 1563 of Regulations 45, the exchange of farm lands

in all cases in which the farm land exchanged has a market value constitutes a completed or closed transaction from which a gain or loss is realized, even though the land received in exchange may be of a similar kind and of similar value.

SECTION 202, ARTICLE 1563: Exchanges of property. 18–20–892 O. D. 480

Holdings of stock in the A Company, including shares held prior to March 1, 1913, shares received as dividends after March 1, 1913, and shares acquired by purchase after March 1, 1913, when the capital stock of the A Company was increased, were exchanged for shares of stock in several other corporations.

The transaction took place in 1918, but owing to the requirements of the Capital Issues Committee, a portion of the stock to be received by the stockholders of the A Company was held in trust during the period of the war, but certificates of ownership were issued and final delivery of the stock made in 1919.

Held, that the exchange constituted a closed transaction which reflected gain or loss in the difference between the aggregate value of the shares exchanged and the total market value of the securities received, and that the date as of which this exchange occurred is the date upon which the respective interests were transferred and not the date upon which complete delivery was made.

In determining the aggregate value of the stock exchanged, the value of the stock received as dividends must be determined in the light of the recent decision of the Supreme Court of the United States in *Eisner* v. *Macomber*, which established the status of such stock with respect to its taxability as income. The essence of this decision is that the issue of stock in the form of dividends does not affect the proportional interest of the shareholder recipient. The only change is in the evidence which represents that interest. The stock dividends and the original shares together represent the same proportional interest that the original shares represented before the issue of the stock as dividends. It follows, therefore, that for the purpose of determining the gain or loss derived from the disposal of the original shares and the shares received as dividends, the value to be used is the total market value as of March 1, 1913, of the original shares of stock. In other words, if a 10 per cent stock dividend was received, one-eleventh of the value of the original shares of stock is to be assigned to the stock received as a dividend for the purpose of computing gain or loss on the disposition of any or all of the stock.

SECTION 202, ARTICLE 1563: Exchanges of property. 26–20–1024 A. R. R. 156

> Held, in the matter of the appeal of A that the difference between the cost of his stock in the M Company, acquired in 1914, and the fair market value of the stock in the N Company at the time of receipt in 1915, constitutes profit or loss for that year.

A has appealed from a decision of the Income Tax Unit fixing a value on the common stock of the N Company at the time it was received in exchange for stock in the M Company.

It appears that A, B, and C secured control of the M Company in 1914 and during the month of June, 1915, the N Company was organized and issued its stock to the owners of stock in the M Company of 1⅔ preferred and 3⅓ common for each share held in the M Company.

It appears that A acquired 500 shares of the capital stock of the M Company on December 9, 1914, at a cost of $2x$ dollars per share. The stockholders of the M Company received in exchange for their stock, stock of the N Company in the ratio stated above. A received for his 500 shares of the capital stock of the M Company 2,500 shares of stock in the N Company of which 800 shares were preferred and 1,700 shares were common.

The formation of the N Company was for the purpose of effecting a reorganization of the M Company and in the brief submitted by the attorneys for the taxpayer, article 1569 of Regulations 45 is quoted and it is strongly urged that this article is applicable to the instant case.

It appears that the Income Tax Unit originally treated this reorganization in 1915 under the provisions of section 202 of the Revenue Act of 1918 and the regulations issued thereunder, and that as a result of this method of handling the transaction an additional tax has been assessed for 1917 upon the theory that section 202 governs in this case and that no profit arose out of the transaction consummated in 1915 whereby A exchanged his 500 shares of stock in the M Company for 2,500 shares of stock in the N Company.

It is contended by the taxpayer in the brief submitted that the stock of the N Company at the time it was received by A in 1915, had a fair market value of x dollars per share for the preferred and $\frac{1}{2}x$ dollars per share for the common. This contention is substantiated by an affidavit submitted by the taxpayer in which he states that the above figures represented the fair market value of the stock at the time of its receipt and also an affidavit of another individual in which he states that he is engaged in the business of buying and selling securities and that he has been so engaged for the past 15 years and that he is familiar with the values of stocks of various kinds.

A received in 1915, 800 shares of the preferred stock of the N Company and 1,700 shares of the common stock of the corporation in exchange for 500 shares of the old stock which cost $2x$ dollars per share. In 1915, 1916, and 1917, A sold shares of this stock at a figure in excess of the par value at the time of the exchange.

These transactions raise two points: (*a*) Should the exchange of stock for stock in a reorganized corporation in 1915 be treated under the provisions of section 202 of the Revenue Act of 1918, and (*b*) what was the fair market value of the stock in the N Company at the time it was received by A in 1915 in exchange for 500 shares of stock in the M Company.

In the consideration of this case the Committee has carefully examined the revenue agent's report, letters of instruction to the revenue agent with respect to the handling of this transaction, and the brief submitted by the attorneys for the taxpayer. It can hardly be said that the provisions of section 202 of the Revenue Act of 1918 dealing with reorganizations, consolidations, or mergers are appli-

cable to a transaction which was consummated in 1915. However, that part of section 202(b) which reads as follows:

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—

put into the 1918 statute a long-established precedent which has been followed by the Income Tax Unit since the adoption of the first income tax statute approved October 3, 1913. The Unit has consistently held that gain or loss arises from the acquisition and subsequent disposition of property when as a result of a transaction between the owner and another person the property is converted into cash or into property that is essentially different from the property disposed of and that has a market value. In the instant case the taxpayer has acquired property through exchange which is substantially different from the property parted with. He has also acquired property which has a market value accurately ascertainable soon after the consummation of the exchange.

In view of the foregoing the Committee finds that the transaction in question must be treated as a completed and closed transaction in 1915, and, further, that the gain or loss should be the difference between the cost in 1914 of the 500 shares of stock in the M Company and the fair market value of the stock of the N Company received in 1915.

With respect to the other question, the Committee feels that the sales of the new stock, preferred and common, made soon after its receipt by the taxpayer, fixes the fair market value of the stock of the N Company. The affidavits submitted to substantiate the sales price of this stock should, in the judgment of the Committee, be accepted as sufficient evidence establishing a fair market value of the stock received in the reorganization. Upon the basis of the affidavits submitted and the statements made in the brief, the Committee recommends that x dollars be considered the fair market value of the preferred stock of the N Company at the time of receipt by the taxpayer, and that $\frac{1}{2}x$ dollars per share be considered the fair market value of the common stock at the time of its receipt by the taxpayer, and that these figures be used as a basis for computing profit upon any subsequent sales of the stock in the N Company.

SECTION 202, ARTICLE 1565: Exchange for different kinds of property. 4–20–698 S. 1294

INCOME TAX: ACT OF OCTOBER 3, 1913, SECTION II, B, DEDUCTIONS.

Deductions for losses—Exchange of bonds of insolvent corporation for stock of new reorganized corporation.

Where a corporation is insolvent and the bondholders bid in the property at foreclosure sale and, for the purpose of reorganization, convey it to a new corporation, receiving in exchange for their bonds stock of the new corporation of the same par value, a bondholder may deduct as a loss, in computing his net income under the Act of October 3, 1913, the amount by which the cost of the bonds, or their fair market value as of March 1, 1913, if acquired prior thereto, exceeds the fair market value, at the time of the exchange, of the stock received by him.

A question is presented upon the following facts: A was one of the large bondholders of the M and P Companies. During the year 1914 both of these companies being insolvent and unable to pay the interest on their bonds, the trustees under the mortgages proceeded to foreclose. Under the foreclosure sale the large bondholders, including A, bid in the properties and formed new corporations to take over the assets of the old companies. Upon the organization of the new corporations both of the old corporations went out of existence.

A exchanged his bonds in each of the old companies for stock in each of the new or reorganized companies, of the same par or face value. On his books he set up a book value for the stock of the new or reorganized companies, based on the amount realized at the foreclosure sales of the property of each of the old companies. The book value deducted from the amounts originally paid by A for the bonds of the old companies so exchanged, resulted in a loss of $11x$ dollars in the securities of one, and $17x$ dollars loss in the securities of the other of the old companies. This amount was claimed by A as a deduction in computing his income tax for the year 1914. It appeared from the report of the internal revenue agent that neither of the old companies had paid interest on their bonds for several years prior to the foreclosure, and that there was nothing to indicate that the bonds had any greater value on March 1, 1913, than at the time of the foreclosure sale the following year. A had apparently owned his bonds for several years, and their cost, used in estimating his loss for the year 1914, does not appear to have represented their value as of March 1, 1913. It appeared that selling and buying stocks and bonds was a part of A's business.

The difference, if any, between the cost of the bonds of the old companies, or their fair market value as of March 1, 1913, if acquired prior thereto, and the fair market value of the stock of the new companies at the time of the exchange, could properly be deducted as a loss for the year 1914. Had A received cash for his bonds, as was the case with the smaller bondholders, there would be no question as to his right to deduct as a loss the difference, if any, between what he received in cash and the cost of the bonds or their market value as of March 1, 1913, if acquired by him prior to that date. Instead of receiving cash, he received stock in the two reorganized companies, the stock being of the same par value as the bonds exchanged for it. Yet the stock was not the equivalent of the bonds exchanged therefor. A was giving up debts for fixed amounts due to him from the old companies and receiving in place thereof fractional interests in the assets of the new companies. The stock of the new companies was such a substantially different interest from that represented by the bonds of the old companies, as to require a comparison of the value of the certificates received with the cost, or March 1, 1913, value, of the bonds surrendered, to determine whether a taxable gain had resulted. (See Solicitor's Memorandum 805.) Had the market value of the stock of the new companies been greater than the cost, or fair market value as of March 1, 1913, of the bonds exchanged for it, A would have had to account for the difference as income for 1914. Similarly, if the fair market value of the stock is less than the

cost, or fair market value as of March 1, 1913, of the bonds exchanged for it, he is entitled to deduct the difference as a loss.

It is true that we have here a case where under a foreclosure sale the mortgagees buy in the mortgaged property. Regulations 45, article 153, provides that in such a situation the property which was security for the debt stands in the place of the debt and the determination of loss is deferred until the property is disposed of. In the instant case, however, the property of the two old companies, which was bid in at foreclosure sale, was later disposed of by the mortgagees (bondholders) to the new or reorganized companies, payment for the same being made in the stock of the new companies. There was a bona fide transfer of the property, title passing from the bondholders to the new companies. It is possible to estimate with reasonable exactness the fair market value of the stock of the new companies at the time the exchange took place, so we do not have to deal with a situation where the stock received has no market value (Law Opinion 434). It is of no consequence that the par value of the bonds is the same as the par value of the stock received in exchange for them, when, as in the instant case, they represent substantially different interests and the fair market value of the stock at the time of the exchange is known (Regulations 45, art. 1563).

It must be noted in the instant case, however, that the bonds of the old companies had paid no interest for several years prior to the foreclosure and appear to have had no greater value on March 1, 1913, than at the time they were exchanged for the stock of the new companies. Such being the case, there would be no deductible loss sustained by A in 1914. Provided, however, he can establish by satisfactory evidence that his bonds on March 1, 1913, had a greater fair market value than the stock received in exchange for them, he is entitled to deduct this difference as a loss for the year 1914.

It is held, therefore, that where a corporation is insolvent and the bondholders bid in the property at foreclosure sale and, for the purpose of reorganization, convey it to a new corporation, receiving in exchange for their bonds stock of the new corporation of the same par value, a bondholder may deduct as a loss, in computing his net income under the Act of October 3, 1913, the amount by which the cost of the bonds, or their fair market value as of March 1, 1913, if acquired prior thereto, exceeds the fair market value, at the time of the exchange, of the stock received by him.

SECTION 202, ARTICLE 1568: Determination of gain or loss from subsequent sale. 4–20–699 T. D. 2963

Article 1568 of Regulations 45 is hereby amended to read as follows:

ART. 1568. *Determination of gain or loss from subsequent sale.*—The new stock and securities received as described in the preceding article take the place of the old stock and securities. For the purpose, therefore, of ascertaining the gain derived or loss sustained from the subsequent sale of any stock of A or of the consolidated corporation, so received, the original cost to the taxpayer or the fair market value as of March 1, 1913, of the stock of B or A in respect of which the new stock was issued, less any untaxed distribution made to the taxpayer by A out of the former capital or surplus of B, or by the consolidated corporation out of the former capital or surplus of A or B, is the basis for deter-

mining the amount of such gain or loss. When securities of a single class are exchanged for new securities of the same total par value but of different classes, for purposes of determining profit or loss on subsequent sale of any of the new securities, the proportion of original cost (or value as of March 1, 1913) to be allocated to each class of new securities is that proportion which the market value of the particular class bears to the market value of all securities received on the date of the exchange. For example, if 100 shares of common stock par value $100 are exchanged for 50 shares of preferred and 50 shares of common each of $100 par value, and the cost of the old stock was $250 per share, or $25,000, but the market value of the preferred on the date of exchange was $110 per share, or $5,500 for the 50 shares, and the market value of the common was $440 per share, or $22,000 for the 50 shares of common, one-fifth of the original cost, or $5,000, would be regarded as the cost of the preferred and four-fifths, of $20,000, as the cost of the common. Similarly, the cost after reorganization, merger, or consolidation of the assets of A or of the consolidated corporation is the sum of the cost (or the fair market value as of March 1, 1913) of the assets of A and of B for the purpose of ascertaining the gain or loss upon a subsequent sale. The new invested capital of A or of the consolidated corporation is to be determined as if A and B were rendering a consolidated return as affiliated corporations. See sections 240 and 326 of the statute and articles 631–638 and 864–869.

SECTION 202, ARTICLE 1568: Determination of gain or loss from subsequent sale. 22–20–967 A. R. R. 126

REVENUE ACT OF 1917.

In re: The appeal of A from the action of the Unit in holding that profit was realized by him upon the sale of certain railroad stock which he owned.

The Committee has had under consideration the appeal of A from a ruling of the Income Tax Unit holding that profit was realized by the taxpayer upon the sale of certain railroad stock owned by him.

The facts appear to be that the taxpayer individually built and owned a railroad which was constructed for the sole purpose of carrying the product of the taxpayer's mills to stations on other roads for distribution. The State Railroad Commission required the incorporation of this road, which was done in 1914. The appraised value of the property as of March 1, 1913, was $30x$ dollars, the cost of additions between that date and the date of incorporation being $12x$ dollars, making a total of $42x$ dollars. Against this amount bonds were issued to the amount of $20x$ dollars, the total proceeds being received by A, reducing his investment on the above basis to $22x$ dollars. Against this the Commission permitted the issuance of stock in the amount of $30x$ dollars. The taxpayer now contends that at the time of incorporation the property was worth the $30x$ dollars for which it was incorporated, and that profit, if any, was made in 1914 at the time of incorporation and a loss suffered when the stock of the railroad was sold in 1917 for $27x$ dollars.

The Unit has ignored the possibility of accretion in value of these assets between March 1, 1913, and the date of incorporation. Whatever accretion there may have been in these values would clearly, under the rulings of the office, be taxable profit when converted into stock of the corporation, since the stock would be deemed to be at least equal in value to the assets behind it.

It is further contended by the taxpayer that under numerous decisons of the office where property is exchanged for stock the stock will be deemed to be worth its par value in the absence of

evidence to the contrary. Had there been no appraisal of the property, the Committee is of the opinion that this position would have been well taken and that the burden of proof would have been on the Government to show that the stock was worth less than its par value had the taxpayer claimed it to be of value equal to or greater than par. However, the appraisal about that time appears to establish that the property turned over to the corporation was worth less than the par value of the stock received. Undoubtedly that appraisal would have been recognized by the Unit in 1914 as establishing the fact that no profit was then realized by the taxpayer had he presented such claim during that year.

The Committee is therefore of the opinion that in the absence of evidence conclusively proving that at the time the property was turned over to the corporation in 1914 it was of greater value than indicated by the appraisal as of March 1, 1913, no profit can be deemed to have been made in 1914, and consequently that the difference between the value of the stock at that time so determined and the sale price of 1917 is taxable profit in the latter year.

SECTION 203.—INVENTORIES.

SECTION 203, ARTICLE 1581: Need of inventories. 20-20-930
S. 1373

INCOME TAX: SECTION 13(b), REVENUE ACT OF 1916.

The delivery of copper bullion to a smelting and refining company where it is mixed with other bullion and concentrates of different metallic contents under a contract by which the smelting and refining company is to return the equivalent of the metallic contents of such ore previously determined by assay, less commissions and other allowable charges, constitutes a sale and not a bailment. Only so much of the metals as had been redelivered by the refining company at the close of the taxable year belonged to and should have been included in the inventory of the taxpayer as of that date.

The M Company has requested permission to file amended returns for the year 1917, excluding from its inventory copper bullion actually delivered to the N Company and including only such refined copper returnable to it under its contract as had not been sold for its account by the N Company.

Section 13(b) of the Revenue Act of 1916 provides that:

Every corporation, * * * subject to the tax herein imposed, shall, on or before the first day of March, nineteen hundred and seventeen, and the first day of March in each year thereafter, * * * render a true and accurate return of its annual net income in the manner and form to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, and containing such facts, data, and information as are appropriate and in the opinion of the Commissioner necessary to determine the correctness of the net income returned and to carry out the provisions of this title. * * *

Article 91 of Regulations 33, revised, provides, in the case of manufacturing corporations, to which for the present purpose the M Company bears a close resemblance, that:

Gross income for the purpose of returns of manufacturing companies shall consist of the total sales plus the inventory at the end of the year less the

sum of the cost of goods or materials purchased during the year and the inventory at the beginning of the year. * * *

In 1914 the N Company and the M Company entered into an agreement which contained the following provisions here material to be considered:

The M Company agreed to deliver to the N Company, hereinafter called the refining company, for refining its output of copper bullion up to a certain amount. The refining company agreed to receive the copper bullion upon its wharf at Y and thereupon to become responsible for the same until the refined contents of copper, gold, and silver were delivered to the M Company. Upon receipt of the bullion the refining company was to treat the same and deliver all the copper, gold, and silver except as otherwise provided to the order of the M Company as provided in the agreement. Copper was to be treated and delivered in 64 days after receipt by the refining company of the shipping documents; each shipment to be reported upon as a whole and to be sampled, assayed, and checked as provided in the agreement. The compensation agreed upon covered all charges, costs, and expenses of every kind and nature. The refining company agreed to sell to the best advantage the copper covered by the contract for account of the M Company, to immediately report the sale to the owner and to account for the proceeds thereof, guaranteeing such sales. As consideration the M Company agreed to pay to the refining company a certain price per ton for the copper delivered and a commission upon the price of the copper realized on sales made by the refining company. It was further agreed that the M Company should have the privilege of disposing of its copper through other channels, if desired, the refining company in such case to receive no commission or charge for selling or guaranteeing.

The vice president of the M Company made affidavit that the ores of the M Company were treated by it at its smelter and when reduced to the form of bullion was shipped and consigned to itself at Y Harbor; that when the bullion arrived there the bills of lading, or delivery orders, were turned over to the refining company which at once took possession of the shipment under the terms of the contract; that upon receipt the refining company became and thereafter was solely responsible for the same and it was so considered and understood between the two companies; that prior to the delivery of the bullion the same was covered by insurance taken out by the M Company in its own name as its own property; that the refining company after the receipt of such bullion treated it in every respect as its own property; that the identity of the property was lost as it was mingled with other copper and treated in the refinery mixed with a great mass of copper bullion derived by the refinery from other sources; that no part of the refined copper delivered to the M Company at any time was necessarily derived from any bullion received from the M Company; that the practice of the refining company was to make sales of the refined copper in its own name as vendor and owner and from time to time to notify its clients of such sales; that this course has been pursued with respect to the sales of refined copper payable to the M Company; that at the end of the year 1916 the M Company had become entitled to receive in the aggregate z pounds of refined copper on account of copper bullion which had been delivered by it under

its contract; that none of this amount was paid for by the refining company in the year 1916, but before the end of that year the refining company notified the M Company that it had made sales in an amount which would much more than absorb all such copper and had thus acquired the right to reserve all such copper and make deliveries of its own under such contract of sale, being under obligation to pay the M Company for all such copper at the sales price; that all the copper above referred to was inventoried as on hand by the M Company at the end of 1916, and arbitrarily valued at x dollars and the company's return for income tax was made on that basis.

From another affidavit it appears that a similar situation existed at the end of the year 1917.

In an affidavit executed by an officer of the refining company the foregoing statements were confirmed and it was further stated that the refining company had always considered itself responsible for the copper from the time of its receipt, and that it was intended that title to the bullion should pass to the refining company at least from the time when it became bound to deliver or pay a specified amount of refined copper; that the bullion received was put into a general mass of copper received by the refinery from other sources and treated at its refineries with such other copper without distinction; that no records were kept from which it would have been possible to determine what percentage of refined copper on hand at any time was actually the product of the bullion theretofore received from the M Company; that this course of business was understood and approved by the M Company; that the refining company considered all such bullion as its own property and so treated it, insuring it in its own name as owner, and understood that its only liability to the M Company was the obligation to deliver, at designated dates, certain specified quantities of refined copper, or upon making sales thereof to pay to the M Company the sale price of the copper less the amount of commission and any other proper charges due under the contract; that such sales contracts were made in its own name as vendor with the consent and approval of the M Company.

In the case of *Woodward* v. *Semans* (125 Ind., 330; 25 N. E., 444), the facts, as stated in the opinion, were that the appellants were dealers in grain, conducting a warehouse and flouring mill; that the appellees agreed to furnish wheat to the appellants, for which the appellants were to deliver to them, on request, a designated number of pounds of flour and bran for each bushel of wheat delivered; that the flour and bran were to remain in the possession of the appellants, subject to delivery upon demand of the appellees; and that before the delivery of all the flour and bran to the appellees, the mill and warehouse of the appellants were burned, and the flour and bran destroyed, without any negligence or wrong on the part of the appellants, and the court said:

> It is the law of this jurisdiction, as well as of many others, that where a warehouseman receives grain on deposit for the owner, to be mingled with other grain in a common receptacle from which sales are made, the warehouseman keeping constantly on hand grain of like kind and quality for the depositor, and ready for delivery to him on call, the contract is one of bailment, and not of sale. [Numerous cases cited.] But the case before us does not fall within the rule which the cases cited assert. On the contrary, it falls within an entirely different rule. There is here no agreement to restore to the original

owner *the identical property*, nor to restore to him property of like quality, nor is there any agreement to restore to him *the product of the property*. The agreement is to yield property in exchange for property, and this is essentially a contract of sale. The appellees were entitled to a designated quantity of flour and bran for each bushel of wheat delivered by them, but they were not entitled to the flour and bran *produced from the particular wheat delivered by them* to the appellants. There was, therefore, no undertaking to restore the wheat either in its original form or in an altered form;

and held that the transaction was a sale and not a bailment.

In *Powder Co.* v. *Burkhardt* (97 U. S., 110, 116) Justice Hunt said:

> It is contended that the question of bailment or not is determined by the fact whether the identical article delivered to the manufacturer is to be returned to the party making the advance. Thus, where logs are delivered to be sawed into boards, or leather to be made into shoes, rags into paper, olives into oil, grapes into wine, wheat into flour, if the *product of the identical articles delivered* is to be returned to the original owner in a new form, it is said to be a bailment, and the title never vests in the manufacturer. If, on the other hand, the manufacturer is not bound to return the same wheat or flour or paper, but may deliver *any other of equal value*, it is said to be a sale or a loan, and the title to the thing delivered vests in the manufacturer. We understand this to be a correct exposition of the law.

The general rule was thus concisely stated by Wallace, J., in *Austin* v. *Seligman* (N. Y.) (18 Fed., 519, 520):

> But the rule is well settled that when, by the terms of the contract under which property is delivered by an owner to another, the latter is under no obligation *to return the specific property either in its identical form or in some other form in which its identity may be traced*, but is authorized to substitute something else in its place, either money or some other equivalent, the transaction is not a bailment, but is a sale or exchange.

Under the rule established by these cases there can be no doubt that the delivery of the copper bullion to the refining company constituted a sale and was so considered by the parties thereto. Upon receipt it was mingled with other bullion and copper concentrates belonging to other parties, including the refining company, of varying grades and values. It thus lost its identity, and the metallic contents which were to be delivered in return therefor were not the particular products of such bullion, nor was it contemplated by the parties that they should be. This is clearly shown by the fact that the amounts of copper, silver, and gold to be returned were determined not by the process of refining but by tests and assays made upon delivery of the bullion to the refining company. The fact that insurance upon the bullion by the M Company ceased upon delivery to the refining company and that thereafterwards the bullion was insured for the account of the refining company is further corroborative of this view.

It must, therefore, be held that upon delivery of the copper bullion to the refining company there was in effect a sale of the bullion to that company at a price payable in specified amounts and weights of copper, silver, and gold, with permission to the refining company, unless otherwise directed by the M Company, to return to it, in the case of the copper, the price for which any of it had been sold by the refining company. The title of the M Company to all bullion delivered by it to the refining company prior to January 1, 1917, or to the metallic contents thereof, had therefore ceased, and no part thereof was properly included in its inventory as of December 31, 1916. The only obligation on the part of the refining company, under

its contract, construed in the light of the facts above set out, was to return to the M Company, within 64 days from receipt of the bills of lading or shipping documents covering the bullion shipments, the equivalent of its metallic contents, or the sales price in the case of any of the copper which had been sold by it in accordance with the authority conferred. Both the copper bullion and the copper and other metals recovered therefrom were the property of the refining company until delivery by it to the M Company or to its order.

In *Buffum* v. *Merry* (R. I.), 4 Fed. Cas. 2112, the facts were that—

A delivered cotton yarn to B on a contract that the same should be manufactured into plaids; B was to find the filling, and was to weave so many yards of the plaids at 15 cents per yard as was equal to the value of the yarn at 65 cents per pound. Held, that by delivery of the yarn to B the property thereof vested in him.

In deciding this case Justice Story said:

My opinion upon this evidence is, that by the contract and delivery, the property in the yarn passed to Hutchinson. It was not a contract whereby the specific yarn was to be manufactured into cloth wholly for the plaintiff's account and at his expense, and nothing but his yarn was to be used for the purpose. There the property in the yarn might not be changed; but here the cloth was to be made of other yarn as well as the plaintiff's, the warp of the plaintiff's yarn, the filling of the defendant's. The whole cloth, when made, was not to be delivered to the plaintiff, but so much only as at 15 cents per yard would pay for the plaintiff's yarn at 65 cents per pound. What is this but the sale of the yarn at a specified price, to be paid for in plaids at a specified price? Suppose after the delivery of the yarn to Hutchinson it had been burnt up, would not the loss have been his? Suppose after the plaids were manufactured, and before delivery of any part to the plaintiff, they had been destroyed, would the loss have been the plaintiff's? Certainly not. The plaids when manufactured would have been *Hutchinson's*, and the plaintiff *would not have been entitled to any part of them before delivery to him* in pursuance of the contract.

Prior to the expiration of this period of 64 days the M Company had no claim to or title in any of the metals returnable to it under the terms of its contract. The refining company was at liberty to sell or otherwise dispose of such copper in its own name and was only liable to the M Company for the payment, within the period fixed, of the stipulated price, either in refined copper, gold and silver, or, in case of sale of the copper, of the price at which it had been sold. Only so much of these metals, therefore, as had been actually delivered to the M Company at the close of the year 1917 belonged to it and should have been included in its inventory as of December 31, 1917.

It necessarily follows from the conclusion just reached that the refined copper returnable to the M Company on December 31, 1917, and December 31, 1918, should, in each instance, have been set up in an account receivable, and if returns were made on an accrual basis, should have been so returned. There is this difference, however, between such an account and an ordinary account receivable, namely, that it is an account receivable in metal and not in money. Under Treasury Decision 2609 and article 1582 of Regulation 45 the copper actually returned to the corporation prior to the dates stated should have been included in the respective inventories as of those dates at cost, or cost or market, whichever was lower, and it would seem clear that the copper receivable could not have had a different

value for the purpose of inventory than that which the copper, if actually received, would have had. For the purpose of determining the value of such account, therefore, the copper receivable should be priced at cost, or cost or market, whichever was lower.

In the case of the refined copper sold by the refining company for account of the M Company, in accordance with the authorization contained in their contract, it is equally clear that the account receivable should show the price at which the copper was so sold and which was guaranteed to the M Company by the refining company.

For the above reasons, the return heretofore filed by the M Company was not "a true and accurate return of its annual net income." It should, therefore, be permitted to file an amended return made in accordance with the rules herein stated.

SECTION 203, ARTICLE 1581: Need of inventories. 24-20-994 O. D. 541

In 1919 an American corporation advanced the sum of x pounds to an English corporation for the purpose of enabling the English corporation to purchase raw material to manufacture certain articles which the American corporation had contracted to sell for the English corporation. At the time the American corporation took its inventory, December 1, 1919, the articles had not been received by it, but were assumed to have depreciated in value owing to the decline in exchange, and the question is presented as to whether or not such exchange could be inventoried at the market value at the date of inventory, the basis being cost or market, whichever is lower.

Article 1581 allows inventory to be taken of raw materials, supplies on hand, partly finished goods, and merchandise held for sale, but it is not permissible to inventory claims which the taxpayer may have against other persons and which have depreciated in value on account of a decline in exchange rates or for any other reason. Inasmuch as the sum of x pounds was a mere advance or loan to the English corporation, it is held that the value of the claim may not be included in an inventory taken for the purpose of determining net income subject to taxation.

SECTION 203, ARTICLE 1582: Valuation of inventories. 3-20-680 A. R. R. 18

> Held, that tobacco companies taking inventory on the monthly average cost method, no method more nearly approaching theoretical accuracy being practically possible, may continue to use such method in reporting for income tax.

This Committee has had under consideration the appeal of several tobacco companies from the ruling of the Income Tax Unit requiring them to submit amended returns for 1917 and 1918 on the basis of actual and specific cost of raw material on hand, and to take their inventories in the future on such basis.

The Advisory Tax Board, at the request of the Income Tax Unit, considered the question of the average cost method of inventories and rendered a very carefully thought out and logical opinion in

Advisory Tax Board Recommendation 48 upon the question. (Cumulative Bulletin, December, 1919, page 47.) The question was not submitted upon the appeal of the companies in question which had not exercised their statutory right to appeal. When they did exercise this right and requested a hearing, in view of the importance of the case it was deemed proper, notwithstanding the Board's opinion on the general question, to give them the hearing which they claimed they had not received upon their specific cases. At this hearing the following conditions, under which practically all the principal tobacco companies operate, were brought out:

First, that there is no dealer, jobber, or middleman to whom the large companies can look for an adequate supply of raw materials. They are forced, therefore, to purchase at first-hand from the grower. The grower of tobacco, after barn-curing same, strips the leaves from the stalks and, after roughly grading them, ties the bundles of leaves into hands of tobacco. These hands of a similar quality are assembled and hauled to market where they are offered at public auction in baskets holding from 10 to 400 pounds, each basket, of course, as nearly as possible containing the same grade and quality of tobacco. The prices which are paid at public auction by the buyers of the larger companies for these baskets of tobacco vary very widely, even on the same day. On bidding in a basket of tobacco the buyer notifies the company conducting the sale of his estimate of the grade of tobacco. At the close of the day, or of a period of sales, all purchases made by a given purchaser are transported to a redrying house, where the tobacco purchased is resorted and regraded and packed into hogsheads for shipment. In this process the exact cost of any particular lot of tobacco contained in the hogshead is necessarily lost, the cost price per pound of the tobacco contained therein being the total cost of all lots purchased and included in the hogshead divided by the number of pounds. The hogsheads of tobacco are then shipped to the company's warehouses, where the tobacco is stored until matured and ready for use. Owing to the different quality of the tobacco of different years' growth and to the necessity of maintaining uniform quality of various brands, the tobacco is usually carried for a considerable period of time and tobacco from crops of three or four years is commonly blended to produce the desired quality. The product of the company must be marketed in containers of statutory size and, in the nature of the business, at a fairly uniform price to the consumer.

The appellants contend very strongly that owing to conditions outlined above it is impossible for them to properly conduct their business on any other basis than averaging the cost of all tobacco on hand, the method adopted being as follows:

The inventory is averaged monthly according to grades; from the inventory of each grade at the beginning of the month is subtracted the tobacco used of that grade, leaving so many pounds costing so many dollars; to this is added the tobacco of that grade purchased during the month, so many pounds costing so many dollars, and a new average determined which is the inventory for the close of the month, and, consequently, the opening inventory for the beginning of the next month, and so on. It must be admitted that such method does not determine the exact cost of the particular tobacco

used during the month and is not exactly indicative of the profits made upon the sales of such tobacco. There can be no question, therefore, that the opinion of the Advisory Tax Board is theoretically correct, but this Committee has reached the conclusion that, although theoretically correct, it is practically impossible to now take inventories for 1917 and 1918 on the basis of actual cost, such cost having been merged in the manner outlined, and impracticable without unjustifiable cost, if possible at all, for the company to change its methods so as to be able to determine exact cost of all tobacco manufactured.

From the method outlined above of purchasing tobacco it is evident that the exact cost of the particular tobacco in a given lot of manufactured goods can not be definitely ascertained under any conditions, but that there must be an average at some point either when the tobacco as purchased from the growers is combined in the redrying house, or by an average of the cost of all purchases of tobacco in a given year, or the monthly averaging of the entire stock on hand, which has been the practice for very many years of all the principal taxpayers engaged in the tobacco industry. The method of averaging on a monthly basis, used in this business, gives greater weight in the costs charged out to manufacturing to earlier purchases than to later purchases. This means that greater weight is given the later purchases in the inventory valuation. It is believed that this method is less objectionable, from a theoretical viewpoint, than an averaging which would give equal or greater weight to the earlier purchases in valuing the inventory. While the method followed does not show exact cost of particular tobacco used, yet if the purchases be discontinued and the entire stock worked out the result upon closing of operations would be that the figures used for costs would represent the exact cost over the entire period of operations.

Section 203 authorizes the Commissioner to require the taking of inventories—

> 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.

In this case the method of inventorying used is not theoretically accurate, but because of the following conditions peculiar to the tobacco industry the taxpayers have demonstrated that theoretical accuracy is not practically possible:

1. Method of purchasing in small lots of varying quantity and quality at widely fluctuating prices.
2. Necessity of regrading and sorting purchases according to quality, color, texture, weight, crop, length and breadth of leaf, etc.
3. Long period of time during which raw material must be held.
4. Fact that crops of different years and from different localities vary in quality, and that crops of different years and different localities must be blended in varying proportions to get proper flavor and uniform product.
5. Fact that oldest purchases are not and can not be used first because of this necessity for blending.
6. Fact that product must be sold in containers, the size of which is regulated by statute at a uniform price.

These and other conditions make it impossible to apply ordinary methods of valuing the inventory of raw material. The widespread and long continued use of the average cost method is evidence that the industry has been unable to devise one which is better. In view of this peculiar combination of circumstances and in accordance with the principle of article 1583, which states, "In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry," the method now used by the tobacco companies in question for inventorying raw materials, as represented to the Bureau, is approved for income tax purposes.

The method followed, as understood by the Committee, is an average cost method and not an average cost or market method. Accordingly, if the market should be below the average cost at the close of a given year, the average cost shall be the basis of valuation and not the lower market price. Companies adopting average cost methods of inventorying for income tax purposes should be required to adhere to that method in future years.

For the reason, therefore, that in the case of the tobacco industry it has been demonstrated that no method more nearly approaching theoretical accuracy than the average cost method is practically possible, the Committee recommends that this method of taking inventories of raw material in the tobacco industry should be recognized and permitted.

SECTION 203, ARTICLE 1582: Valuation of inventories.

(See 5-20-721; sec. 1, art. 1510.) Inventory value of stock purchased for Government contracts.

SECTION 203, ARTICLE 1582: Valuation of inventories. 9-20-765 A. R. M. 33

(Also Section 214(a) 12, Article 263.)

The Committee is in receipt of a request for advice as to whether or not liquor dealers should be permitted to inventory floor stocks and stocks in bonded warehouses on December 31, 1919, at nothing for income tax purposes with the understanding that should the goods be later sold the full amount received therefrom must be returned as income.

While the Committee recognizes the serious situation in which liquor dealers found themselves at the close of the year 1919 because of the effect of the prohibition law, it fails to find in the law any warrant for eliminating from the inventoried goods which have not been destroyed or abandoned as worthless but which are recognized as having some value. The prohibition law, as understood by the Committee, permits the use of distilled liquors and wines in the manufacture of medicines and in the filling of prescriptions for medicinal use. The provision for these legitimate demands, therefore, gives to the goods

available to supply them some value, and it is presumed that there can be readily established the market value for the supplying of such demands. It is true that the demand is not sufficient to create a market for all the goods held in stock, and that an attempt to sell for this purpose at one time very considerable part of the stocks on hand would doubtless flood the market and break it down to a very low figure. In a measure, however, this was true before the enactment of prohibition laws, as the supply of liquor on hand was always in excess of any immediate demand therefor.

The Committee is therefore of the opinion that unless stocks of liquors were on December 31 destroyed, given away to hospitals and other charitable institutions, or abandoned to the proper authorities as worthless, in which event they would not be included in the inventory on December 31, they must be taken into the inventory at cost, or at cost or market, whichever is lower, and that there is no warrant of law for ignoring stocks on hand in taking inventories at the close of 1919 with the understanding that should they subsequently be disposed of for value, the total value received would be reported as income of the year in which disposed of.

SECTION 203, ARTICLE 1582: Valuation of inventories. 13–20–804 A. R. M. 38

CHANGE OF BASIS OF PRICING INVENTORIES.

Advice has been requested by the Income Tax Unit as to procedure when request is made by a taxpayer to change his basis of pricing inventories from cost, to cost or market, whichever is lower, or when it is discovered that inventories have been taken in the past on some basis not authorized by the regulations.

It is the judgment of the Committee that when request is made for permission to change from cost or market, whichever is lower, to cost for pricing inventories at the close of 1919, no objection is seen to granting the permission, since it will have no effect on the tax if market was above cost at the close of 1918 and will increase the tax if market was lower than cost at that date; permission to be granted of course upon the condition that the new method will be followed consistently hereafter.

If inventories have been taken in the past on the basis of cost and request is now made to change to "cost or market, whichever is lower," the reasons for the request should be carefully scrutinized and the request refused if it appears that the principal reason therefor is to reduce the tax payable for 1919.

If the request *is* granted, however, in either of the above cases, it is unnecessary to require any amended returns for past years or any change in the opening inventory by reason of the changed method of pricing.

Where change is necessitated because in the past a basis has been used not permitted by the regulations, now or then, amended returns, on one or the other of the two bases now authorized, from 1915 to date should be filed.

If the adjustments due to the amendment of returns as required above so affect the taxpayer as to occasion an inequality in the tax

prior to the year 1915, such inequality may be remedied in the return for 1915 by the deduction from, or addition to, the tax accruing in that year of an amount equal to the net amount overpaid or underpaid in prior years; such amount to be determined by filing, with the return for 1915, a composite return for all prior years, accompanied by a statement showing the total adjustment for each of the years and the net for the entire period.

SECTION 203, ARTICLE 1582: Valuation of inventories. 23–20–982 A. R. R. 140

Held in the case of A & Company that carrying charges actually paid or accrued on liquor in bond are, under certain circumstances, proper additions to the cost price of such liquor for the purpose of inventory.

A & Company, a partnership consisting of A, B, and C, was engaged in the wholesale liquor and cigar business.

This case has been referred to the Committee on Appeal from a decision of the Income Tax Unit in regard to the following question, viz: The valuation of liquor inventories at the beginning of business January 1, 1917, and at the close of business December 31 of that year.

On December 31, 1916, the firm had in bond and in its wholesale house a quantity of whisky carried on its books at an actual cost of $16x$ dollars, which for inventory purposes it increased to $19x$ dollars by the addition of certain "carrying charges" amounting to $3x$ dollars. On December 31, 1917, it had in bond and in its wholesale house a quantity of whisky carried on its books at a cost of $9x$ dollars, which for inventory purposes it increased to $10x$ dollars by the addition of similar carrying charges amounting to x dollars. These charges did not represent actual disbursements nor had they ever been accrued and set up on the books of the company as a liability, nor in fact had the amounts of them ever been actually determined. For inventory purposes for the year 1917 only, A & Company determined the value of its whisky in bond by the use of a publication which purports to determine the actual value of whisky in bond based on the experience of the trade, including as factors the cost price plus county, State, and Federal taxes, storage charges, interest, and appreciation in value through "ageing" of the liquor.

If the actual accrued charges which must eventually be paid by the firm, either directly, or indirectly through credits to customers, can be accurately determined and applied to the liquor actually in stock at any specific date, such charges, if set up on the books as an existing liability, form proper additions to the cost price of the liquor then on hand; but this additional value must be determined by charges actually paid or to be paid and can not be arrived at by the application of any empirical formula and can not in any case include interest except on money actually borrowed for the purpose of carrying the liquor, nor any appreciation in value of the liquor through "ageing."

It is obvious that if adjustments of the character above indicated are applied to the opening inventory for 1917, they must also be applied to the closing inventory of 1916 and to all previous inven-

tories by which the tax returns are affected, with the result that amended returns would be necessitated for all such prior years.

The record before the Committee does not contain the necessary facts to enable it to determine the question involved, and the Committee therefore can do no more than enunciate the principles in accordance with which this question should be answered when the facts are definitely ascertained by the Unit.

SECTION 203, ARTICLE 1585(a): Inventories of live stock raisers and other farmers. 2-20-668 A. R. R. 14

The farm price method of taking inventories, which method contemplates valuation at market less cost of marketing is approved.

It appears that the farm price method of valuing inventories is in wide use among farmers. The method consists of valuing at market less cost of marketing.

Unsurmountable difficulties attend any attempt to take inventories on a cost basis, particularly in the case of stock farms. Some live stock is purchased and other live stock is raised. Information reaching the Committee is to the effect that ordinarily no method is in use to distinguish the live stock bought from that raised, so that identification at the time of taking inventory does not exist. The cost method of inventorying of stock raised is hardly practicable for a number of reasons connected with the breeding of the animals, some being retained for breeding purposes and others sold.

The proposed method appears to embody nothing that would be detrimental to the Government and is used in practice. This method appears to be the one found by experience to be the most expedient as a basis of valuation.

A change in method raises questions as to the initial inventory. Certain stock has been raised, and under previous methods of reporting the entire cost of raising has been charged for a number of years against income. If the beginning inventory of the year in which the method is changed were to be adjusted without regard to these deductions—that is, without a credit to income for the value brought into the new opening inventory that was not in the closing inventory—then a deduction would be allowed twice for the same item of cost. For example, if at the end of 1918 the inventory included only stock purchased, and if the farmer were permitted to add to this inventory, for purposes of opening inventory in 1919, the market value of stock raised, such addition would increase the cost of stock sold (under the ordinary method of finding the cost of stock sold in accounting) and thus decrease the profits. Accordingly, the Committee has given consideration to this feature and recommends that the following rules be adopted:

(*a*) That farmers at their option may in valuing closing inventory for the year 1919 use the farm market method above described.

(*b*) That in absence of conditions stated in paragraph (*c*) below such farmers as use this method bring in their opening inventory for 1919 at the same value as the closing inventory for 1918 (this being the same in effect as valuing the opening inventory on the new basis and crediting income with the excess valuation brought in).

(*c*) If the farmer finds that the treatment under paragraph (*b*) results in abnormally large income for the year 1919, by reason of the fact that certain stock which was on hand at the beginning is still on hand at the end of the year, then adjustments may be made of taxes, based on the new method of taking inventories, from and including the year 1915 (using for that year the same method as suggested for 1919 above).

It is recommended that the adjustments specified in paragraph (*c*) above be not in the form of amended returns, but in the form of an adjustment sheet attached to the 1919 return.

SECTION 203, ARTICLE 1585(a): Inventories of live stock raisers and other farmers. 18–20–907 T. D. 3011

Regulations 45 are hereby amended by inserting after article 1585 a paragraph to be known as article 1585(a), reading as follows:

ART. 1585(a). *Inventories of live stock raisers and other farmers.*—Because of the impracticability of identifying live stock purchased and live stock raised, and the difficulty of ascertaining actual cost of live stock and other farm products raised, farmers who render their returns upon an accrual basis may at their option value their inventories for the taxable year according to the farm price method which contemplates a valuation of inventories at market price less cost of marketing. If the use of the farm price method of valuing inventories for any taxable year represents a change in method of taking inventories from that employed in prior years, the opening inventory for the taxable year in which the change is made should be brought in at the same value as the closing inventory for the preceding taxable year (this being the same in effect as valuing the opening inventory on the new basis and crediting income with the excess valuation brought in). However, if such treatment of the opening inventory for the taxable year in which the change is made results in abnormally large income for that year, by reason of the fact that certain live stock or other farm products which were on hand at the beginning are still on hand at the end of the year, then adjustments in the form of an adjustment sheet attached to the return for such taxable year may be made of the taxes for 1915 and each succeeding year to the year in which the change is made. In making such adjustments the farm price method of valuing inventories should be used for each of the preceding taxable years.

SECTION 203, ARTICLE 1585(b): Inventories of lumber manufacturers. 24–20–995 T. D. 3024

Regulations 45 are hereby amended by inserting after article 1585(a) a paragraph to be known as article 1585(b), reading as follows:

ART 1585(b). *Inventories of lumber manufacturers.*—1. Because of the impracticability of determining accurately the costs properly assignable to each species, grade, and dimension of lumber making up the product of the mill, lumber manufacturers may use as a basis for pricing inventories the average cost to the manufacturer of producing the inventoried products during the taxable year for which the return of net income is made.

2. If the quantity of lumber on hand at the time of inventory is greater than the total quantity of lumber produced during the current taxable year, it is evident that the excess stock has been carried over from the previous year's production, and such excess shall be valued at the average cost of production for the preceding taxable year.

3. A taxpayer who regularly allocates in his books of account such average cost to the different kinds and grades of lumber in proportion to the selling

value of such kinds and grades may, subject in each case to the approval of the Commissioner upon audit of the return, make his returns of net income on that basis.

4. The term lumber manufacturer, as used in this article, means a person who manufactures lumber from logs, as distinguished from a remanufacturer of lumber.

SECTION 204.—NET LOSSES.

SECTION 204, ARTICLE 1601: Scope of net losses. 3–20–681
O. D. 367

If on account of losses through floods, a taxpayer sustains a net operating loss in 1919, he may file with his 1919 return a claim on Form 46 to have such net loss deducted from his net income for 1918 and the tax for 1918 redetermined in accordance with section 204, Revenue Act of 1918.

SECTION 204, ARTICLE 1601: Scope of net losses.

(See 4–20–703, sec. 214(a) 4, 5, 6, art. 141.) Treatment of loss sustained by stockholder of two corporations which failed and were liquidated.

SECTION 204, ARTICLE 1601: Scope of net losses. 14–20–822
O. D. 430

An individual who sustained a net loss for a taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, with respect to his share of partnership earnings is not entitled to the relief provided by section 204 of the Revenue Act of 1918, unless he has sustained a net loss for such taxable year with respect to his entire income derived from all sources during that year.

SECTION 204, ARTICLE 1601: Scope of net losses. 15–20–841
O. D. 445

If a taxpayer changes his accounting period in such manner that the period from the close of his previous taxable year to the close of his newly established taxable year falls between October 31, 1918, and January 1, 1920, and he sustains a net loss during such fractional year period, he is not entitled to the relief provided by section 204 of the Revenue Act of 1918, since the net loss sustained is not for a full taxable year as provided by the Act.

SECTION 204, ARTICLE 1601: Scope of net losses. 21–20–947
O. D. 511

A corporation whose taxable year is not included in the period between October 31, 1918, and January 1, 1920, is not entitled to the relief afforded by the provision of section 204 of the Revenue Act of 1918 with regard to "net losses." The wording of the Act is very specific on this point.

Consequently a corporation doing business on a fiscal year basis may not allocate its net loss and deduct the amount apportioned to that part of its fiscal year falling within the period October 31, 1918, to January 1, 1920.

SECTION 204, ARTICLE 1601: Scope of net losses. 26–20–1025 O. D. 558

Section 204 of the Revenue Act of 1918, relating to net losses, is applicable to net losses sustained by farmers. Any farmer who in 1919 suffered a net loss, as defined in section 204, may adjust his 1918 tax as provided therein.

SECTION 204, ARTICLE 1603: Allowance of net loss. 14–20–823 O. D. 431

If a taxpayer suffers a net loss as defined in section 204(a) of the Revenue Act of 1918 for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, and *had no net income* for the preceding taxable year, the entire amount of the loss is deductible in computing net income for the succeeding taxable year.

SECTION 205.—FISCAL YEAR WITH DIFFERENT RATES.

SECTION 205, ARTICLE 1621: Fiscal year with different rates.

(See 14–20–833; sec. 218, art. 324.) Rates of tax applicable to distributive shares of members of partnership with fiscal year ended in 1916.

SECTION 205, ARTICLE 1625: Fiscal year of corporation or individual ending in 1919.

(See 15–20–850; sec. 218, art. 334.) Taxation of stockholders where personal service corporation changes from fiscal year to calendar year.

PART II.—INDIVIDUALS.

SECTION 210.—NORMAL TAX.

SECTION 210, ARTICLE 4: Who is a citizen. 23–20–983 O. D. 533

The death of the husband of a woman who, prior to her marriage to a nonresident alien, was an American citizen, does not of itself restore her American citizenship. If she has not registered as an American citizen with a consul of the United States within one year after the death of her husband, or has not returned to reside in the United States, she retains the status of her husband and is therefore taxable as a nonresident alien. (Sec. 3, Act of March 2, 1917.)

SECTION 212.—NET INCOME DEFINED.

SECTION 212, ARTICLE 21: Meaning of net income.

(See 18–20–899; sec. 214(a) 4, 5, 6, art. 141.) Effect on net income for Federal income tax purposes of Federal or State restrictions on taxpayer's activities.

SECTION 212, ARTICLE 22: Computation of net income. 3–20–682 A. R. R. 15

The Committee has reached the conclusion that under the abnormal conditions characterizing foreign exchange during the European war, the taxpayer may convert current assets less current liabilities payable in the foreign currency at the current rate of exchange or at any rate less favorable to him. The Commissioner should consider in any case applications to adopt a rate more favorable to the taxpayer or may on his own motion apply such a rate where the facts in the particular case warrant such departure.

This ruling should apply primarily to taxpayers trading or manufacturing in foreign countries and should not be held to apply to isolated or collateral investments in foreign credits or securities.

SECTION 212, ARTICLE 22: Computation of net income. 13–20–805 O. D. 419

Income returnable for the purpose of Federal taxes should be expressed in terms of United States money. The rate of exchange at the time of receipt governs in making the computation.

SECTION 212, ARTICLE 22: Computation of net income. 16–20–873 O. D. 459

Income received by a citizen of the United States residing abroad from foreign sources in foreign money or credits should be reported in terms of United States money on the basis of the rate of exchange in effect at the time it was actually received; however, no application of exchange rates is necessary in the case of income received in the form of United States currency by a citizen of the United States residing abroad.

SECTION 212, ARTICLE 22: Computation of net income. 19–20–909 O. D. 489

A taxpayer purchasing goods from a foreign country, the value of such goods being quoted in terms of the foreign currency, should enter the cost thereof at the current or market rate of exchange prevailing at the time that payment for the goods is actually made.

In the case of a domestic corporation engaged in business in a foreign country, its assets and liabilities (other than capital assets) recorded on its books in terms of the foreign currency, should be appraised in dollars (whether actually converted or not) at the close

of each taxable year in which it is engaged in active business at the current or market rate of exchange, if any, then prevailing. (But see A. R. R. 15, 3–20–682.)

SECTION 212, ARTICLE 22: Computation of net income. 25–20–1009 O. D. 550

A domestic corporation has a branch office in London which keeps a separate set of books in English currency and renders a report at the end of the year as to the profits. During the year, whenever the branch office has on hand more money than is needed for regular expenses, a remittance is made to the home office.

Held, that the net profits of the London branch for the year should be computed in English currency. From the total profits for the year should be subtracted the total amount remitted to the home office during the year, all expressed in English currency. To determine the equivalent of the profits in terms of United States money, the amounts remitted should be converted into United States money at the rate of exchange in effect at the date such remittances were made. The balance of the net profits, expressed in English currency, should be converted into United States money at the rate of exchange as of the end of the taxable year, regardless of the fact that the profits may not have been remitted to the home office.

SECTION 212, ARTICLE 22: Computation of net income. 25–20–1010 O. D. 551

The following rates have been accepted by the Bureau of Internal Revenue as the current or market rates of exchange prevailing as of December 31, 1919:

London	3.765	(dollars to £ sterling)
Australia	3.80	(dollars to £ sterling)
New Zealand	3.80	(dollars to £ sterling)
Paris	10.85	(francs to dollars)
Belgium	10.80	(francs to dollars)
Milan	13.25	(lire to dollars)
Madrid	.1925	(cents to peseta)
Stockholm	.2140	(cents to kroner)
Christiania	.2020	(cents to krone)
Copenhagen	.1910	(cents to krone)
Amsterdam	.37375	(cents to guilder)
Buenos Aires	1.01375	(pesos to dollars)
Montevideo	.95	(centavos to dollars)
Rio de Janeiro	.28	(cents to gold milreis)
Lima	4.74	(dollars to Peruvian £)
Mexico City	.50375	(cents to pesos)
Manila	.485	(cents to pesos)
Calcutta	.4525	(cents to rupee)
Singapore	.54	(cents to Singapore dollars)
Germany	.0203	(cents to marks)
Poland	.0092	(cents to marks)
Austria	.006	(cents to kroner)
Czechoslovakia	.0175	(cents to kroner)
Jugoslavia	.009	(cents to kroner)
Greece	.1490	(cents to drachma)
Roumania	.0290	(cents to leu)
Bulgaria	.0230	(cents to lev)
Serbia	.0430	(cents to dinar)
Finland	.0310	(cents to markka)

SECTION 212, ARTICLE 23: Bases of computation. 2-20-669
A. R. M 16
(Also Section 213, (a) Article 31.)
(Also Section 214 (a)1, Article 101.)

If, in pursuance of a contract, a vendee corporation agrees to pay the income and excess profits taxes, on profits arising out of the sales returned by the vendor corporation on a calendar year basis, such vendee corporation may, if it reports on an accrual bases for a fiscal year ending in October of the calendar year, submit an amended return in which the extent of the accrual of such taxes in such fiscal year is deducted from income. If, however, such contracts are regularly entered into by the vendee corporation as a consistent practice, the vendee corporation should be allowed the deduction as for the year in which the taxes are paid or determined, unless gross distortion of income, as between years, results.

The vendor corporation, under the circumstances given, reports as income the amount of taxes as for the year *for* which payment is made.

A contract was entered into between the P Company, and the M Company, whereby the latter agreed to sell certain goods on a cost-plus basis, it being provided that the P Company should pay Federal taxes assessed on the profits accrued from this contract to the M Company.

It appears that this contract was entered into in July, 1917, and was carried out by the M Company during the year 1918. In October, 1918, the P Company closed its books upon an accrual basis and made no provision for any taxes arising out of the contract. The amount of these taxes, as at October, 1918, was indeterminable for the reason that the M Company reported on a calendar year basis for 1918. The amount for the calendar year was subsequently ascertained to be x dollars.

(*a*) Is the amount agreed to be paid by the P Company to be considered income of the M Company; and, if so, for what year shall it be returned?

(*b*) May the P Company submit an amended return for the fiscal year ending in October, 1918, allocating the deduction for the taxes paid under the contract as between that fiscal year and the succeeding fiscal years?

Answering the first of these questions, it is held that the amount of taxes of the M Company paid by the P Company is income of the M Company as for the year for which paid—that is, 1918.

The answer to the second depends upon the practice under the accrual system of accounting, in conjunction with the rulings of the Bureau on approximated amounts of deductions.

Under an accrual system of accounting it is the consistent practice of accountants to allow for indeterminable amounts which will become obligations of the business organization. This is done by estimates, the estimated amount being deducted from income and representing an approximation of the extent of the incurrence of the liability for the year in which deducted.

By reason of the fact that these amounts are based upon judgments, and for other administrative reasons, the Bureau has not recognized such estimated deductions, in many instances, for the year in which made. This is illustrated by the attitude of the Bureau toward many

reserve accounts set up as a regular and consistent practice under the accrual system of accounting.

If the liability is of a character regularly incurred, the probabilities are that no very appreciable distortion results if the deduction is allowed as for the year in which paid or determined. Accordingly, if the consistent practice of the P Company is to enter into contracts of this character, or if the contract thus entered into extends over a number of years, then the deduction by the P Company should be made as for the year in which the amount is determined or paid, unless gross distortions of income result.

If, on the other hand, such contracts are not consistently entered into by the P Company, or the contract in question does not cover a number of years, then a different rule must be invoked. All income of the P Company for the fiscal year ending in October, 1918, was reported on an accrual basis, and likewise all deductions from income. If an amount as large as x dollars is deducted as for the fiscal year ending in 1919, with no deduction as for the fiscal year ending in 1918, the result would not truly reflect the income either for the taxable year ending in October, 1918, or that ending in October, 1919. Accordingly, in cases of this kind, where gross distortion of income between years would result from a rule that the deduction is to be made in the year when determined or paid, the requirement of the Act that returns should be made on a basis which truly reflects income should be carried out to the extent of having amended returns submitted which will truly reflect such income.

The fact that no provision was made by the P Company for this liability element does not alter the situation. Under an accrual method of accounting, it is customary and usual to make such provision. The estimated amount might not have been allowed as a deduction from income for the administrative reasons to which reference has been made. If such contracts were a consistent policy of the P Company, the deduction would be allowed as for the year in which payment is made or the amount determined. If not a consistent policy of their business, then such adjustments would be made as would clearly reflect the income between years.

Accordingly, it is recommended that P Company be permitted to submit an amended return for the fiscal year ending in October, 1918, in which such part of the amount of these taxes as is apportionable to that fiscal year is deducted. The M Company should report as income for the calendar year 1918 the amount of these taxes.

It is further recomemnded that as much of ruling 11–19–371, O. D. 210, as is inconsistent with this memorandum be revoked.

SECTION 212, ARTICLE 23: Bases of computation.

(See 2–20–674; sec. 214(a) 10, art. 202.) Depletion deductions when a taxpayer's returns are made on a basis of cash receipts and disbursements and he receives in one year royalties which have accrued over a number of years.

SECTION 212, ARTICLE 23: Bases of computation. 7-20-738 S. 1312

INCOME EARNED PARTLY IN 1916 AND PARTLY IN 1917.

Where an individual is employed as an agent for a firm and under his contract is to receive as compensation 50 per cent of the profits of the agency which may be appropriated by him monthly as earned, the amount actually appropriated constitutes income of the agent for the year in which appropriated.

Section 2(a) of the Revenue Act of 1916, as amended by the Revenue Act of 1917, provides that:

The net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal services of whatever kind and in whatever form paid, * * *.

Section 8(g) provides that:

An individual keeping accounts upon any basis other than that of actual receipts and disbursements * * * may * * * 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.

The evidence presented in support of the claim shows that the claimant is an agent of M, and, under the agency agreement between the claimant and M, the claimant receives 50 per cent of the profits of the agency which profits he may draw at any time. The agreement provides that all accounts connected with the business either with banks or elsewhere, whether for moneys, drafts or other matters pertaining to the business, must be kept in the name of A, agent for M, and it is understood and agreed that all such moneys and all papers, securities and documents connected with the business shall be and are the property of M; that it shall be the duty of A to furnish financial statements of the business on the first day of each calendar month, which statements shall give the true and accurate status of the business for the preceding month, and each statement shall be accompanied by a trial balance; and that A shall at no time overdraw his salary unless he receives specific permission in writing to do so from M.

B, a partner of M, states that he has been a member of the partnership for a period of over 10 years and is thoroughly familiar with the affairs and general business of the partnership; that during the season of 1916-17, as in prior seasons, A had the absolute right to draw each month his one-half of the net profits for the month. That the said A had exclusive control of the moneys of said agency and that the bank accounts were kept in his name as "A, Agent," and that he had the sole right to sign checks thereon and at any time to transfer to his own personal account his share of the monthly net profits of the agency; that A did from time to time so draw and transfer to his own personal account or pay to his use such money as he chose and that the only provision in the contract limiting the same was that he should not overdraw his one-half of the net monthly profit.

In making his returns of net income for the years 1917 and 1918, the claimant reported his income from all sources, other than the agency, received during the calendar year covered by the return, and his net earnings from the agency as shown for the fiscal year

ending June 30. For the calendar year 1917, he included in his return as commissions received from the agency for the fiscal year ending June 30, 1917, the amount of $4x$ dollars. He has been subjected to both income and excess profits tax (at the rate of 8 per cent) upon the commissions thus reported. A now claims that one-half of these profits, or $2x$ dollars, should be allocated to the year 1916, and that he should be exempt from excess profits tax upon such amount. The evidence further shows that of the amount of the profits to which he was entitled during the last six months of 1916, A actually appropriated to his own personal account only x dollars.

In making his return of income for the year 1918, A apparently included the portion of the profits for the fiscal year ending June 30, 1918, actually placed to his credit during the calendar year 1918 and also such portion of the earnings of the agency for the fiscal year ending June 30, 1919, as was placed to his individual account during the calendar year 1918.

The claim presents a number of questions, among which are the following:

(1) Whether the claimant is entitled to exclude from his 1917 return one-half of the earnings of the agency for the fiscal year ending June 30, 1917.

(2) If so, whether he should be required to include in his 1917 return one-half of the earnings of the agency for the fiscal year ending June 30, 1918.

(3) Whether the claimant should be permitted to exclude from his 1917 return x dollars, the earnings for the last six months of 1916 (included in the fiscal year ending June 30, 1917).

(4) If so, whether he should be required to include in his 1917 return, in place of x dollars excluded, the amount of the earnings actually appropriated by him or placed to his personal account during the last six months of 1917.

With respect to the first two questions propounded there is no evidence to show that one-half of the earnings for the fiscal year ending June 30, 1917, may properly be allocated to the year 1916. The monthly statements made by the claimant do not exactly state the profits of the agency for the month although the estimate of the earnings for the month is a close approximation to the actual earnings, and probably less rather than more than the actual earnings. The contract, under which the claimant acts as agent, specifically provides, however, that all "moneys, and all papers, securities and documents connected with the business shall be and are the property of M." Therefore, as to the earnings which are not actually appropriated by the claimant, it must be held that they are not his and do not constitute his income.

Attorneys for the claimant make the contention that the claimant's portion of the monthly profits of the agency constitute income of the claimant each month; that is to say, the claimant's share of the profits are received by him during the month in which earned. This contention is based upon the ruling of this office contained in article 53 of Regulations 45, the working of which is "income which may be drawn at any time is subject to the tax for the year during which so

credited or set apart, although not then actually reduced to possession." This contention is not valid for the reason that the profits of the agency are not credited to him or set apart month by month. The contract of employment provides that such profits "shall be and are the property of M."

With reference to the third and fourth questions presented, it is to be noted that the claimant may draw his compensation at any time, but that he must not appropriate to his own use more than actually belongs to him. Apparently he was clearly entitled to the x dollars drawn by him during the first six months of the fiscal year, ending June 30, 1917. Therefore, it must be held that this x dollars was income of the claimant for the year 1916. The balance of his net share of the commissions for the fiscal year must be allocated to the year 1917; that is $3x$ dollars of the amount of the commissions shown in his 1917 return was correctly included in that return. In addition to this amount, there must be included in the 1917 return his share of the commissions earned during the fiscal year ending June 30, 1918, actually appropriated by him during the last six months of 1917. Oral evidence made in connection with this claim indicates that there was not included in the 1917 return any amount representing commissions drawn by the claimant during the last six months of 1917.

It is held that where an individual is employed as an agent for a firm and under his contract is to receive as compensation 50 per cent of the profits of the agency which may be appropriated by him monthly as earned, the amount actually appropriated constitutes income of the agent for the year in which appropriated.

SECTION 212, ARTICLE 23: Bases of computation.

(See 15–20–851; sec. 219, art. 341.) How accrued interest due to a decedent should be reported in returns filed by an executor or administrator.

SECTION 212, ARTICLE 23: Bases of computation. 18–20–893
(Also Section 213(a), Article 38.) O. D. 481

Where the return of a farmer rendered upon an accrual basis represents a change from that of cash receipts and disbursements, the gross profits for the current taxable year must be computed without deducting from the sum of the closing inventory and the sales and other receipts, the inventory at the beginning of the year except—

(*a*) If any live stock, grain, or other property on hand at the beginning of the taxable year had been purchased and the cost thereof not charged to expense, only the difference between the cost and the selling price should be reported as income for the year in which sold.

(*b*) But if the cost of such property has been charged to expense for a previous year, the entire amount received must be reported as income for the year in which sold.

This procedure is to be followed in such cases instead of attempting to make an adjustment by recomputing the net income for prior years upon the accrual basis with inventories.

SECTION 212, ARTICLE 25: Accounting period. 18–20–749
O. D. 404

A newly organized corporation may file its income and profits tax returns on a fiscal year basis without applying to the Commissioner for permission to do so, provided such basis is definitely established and the books are kept in accordance therewith prior to the close of the first fiscal year.

SECTION 212, ARTICLE 26: Change in accounting period. 24–20–996
(Also Section 226, Article 431.) Sol. Op. 5

INCOME TAX: SECTION 226, REVENUE ACT OF 1918.—RETURNS.

A taxpayer, having filed a return for a fiscal year ended June 30 and desiring to change to a calendar year basis, must file notice thereof at least 30 days prior to March 15 of the following year. Solicitor's Memorandum 857 modified accordingly.

A question is raised as to the correctness of Solicitor's Memorandum 857 and a letter apparently based thereon. The provisions of law dealt with in the memorandum are those of section 226 of the Revenue Act of 1918, which provides:

That if a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31.

In article 26, Regulations 45, it is stated:

The Commissioner will not approve a change of the basis of computing net income unless such notice is given at a time which is both (*a*) at least 30 days before the due date of the taxpayer's return on the basis of his existing taxable year and (*b*) at least 30 days before the due date of his return on the basis of the proposed taxable year.

In article 431 it is stated:

* * * The requirements with respect to the filing of a separate return and the payment of tax for a part of a year are the same as for the filing of a return and the payment of tax for a full taxable year closing at the same time.

The facts of the case dealt with in Solicitor's Memorandum 857 appear to be that a concern which had been making its returns on the basis of a fiscal year ending June 30 desired to change to a calendar year basis. It filed a return for the fiscal year ended June 30, 1918, and apparently did not file notice of the proposed change until April 10, 1919. The date for the making of the next return upon the basis of the old fiscal year would have been September 15, 1919. The date is incorrectly stated in the Solicitor's Memorandum as August 15 and it is held therein that, inasmuch as the taxpayer had given notice more than 30 days prior to that date, it was sufficient, and that the corporation had until August 15, 1919, to file a return for the six months ended December 31, 1918.

This appears to be an erroneous application of the regulations. The statement in article 26 of the said regulations, that a change in the basis of computing net income would not be approved unless

"notice is given at a time which is both (*a*) at least 30 days before the due date of the taxpayer's return on the basis of his existing taxable year, and (*b*) at least 30 days before the due date of his return on the basis of the proposed taxable year," doubtless has reference to the next return due either on the basis of the old or new accounting period. The taxpayer had filed a return for the fiscal year ended June 30, 1918. The next return on the basis of the proposed taxable year would have been for the six months ended December 31, 1918, and a return for that period would have been due March 15, 1919. It was accordingly necessary for the taxpayer to make request at least 30 days prior to March 15, 1919, and make return for the last six months of the previous year before that date.

This, it appears, is the manner in which the law is actually being enforced. This manner of enforcement is believed to be correct, and Solicitor's Memorandum 857 is modified accordingly.

WAYNE JOHNSON,
Solicitor of Internal Revenue.

SECTION 212, ARTICLE 26: Change in accounting period. 26–20–1026
T. D. 3032

ART. 26 of Regulations 45 is hereby amended to read as follows:

ART. 26. *Change in accounting period.*—If a taxpayer changes his accounting period, and not merely his taxable year to conform with his existing accounting period, he shall as soon as possible give to the collector for transmission to the Commissioner written notice of such change and of his reasons therefor. The Commissioner will not approve a change of the basis of computing net income unless such notice is given at a time which is both (*a*) at least thirty days before the due date of the taxpayer's return on the basis of his existing taxable year and (*b*) at least thirty days before the due date of his separate return for the period between the close of the existing taxable year and the date designated as the close of the proposed taxable year. The due date of the separate return for such period is the fifteenth day of the third month following the close of that period. If the change in the basis of computing the net income of the taxpayer is approved by the Commissioner, the taxpayer shall thereafter make his returns upon the basis of the new accounting period in accordance with the requirements of section 226 of the statute and his net income shall be computed as therein provided. See Article 431.

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

SECTION 213(a), ARTICLE 31: What included in gross income.

(See 2–20–669; sec. 212, art. 23.) Amount to be included in gross income by a vendor when, according to contract, a vendee pays Federal income and excess profits taxes on profits on sales made by the vendor to the vendee.

SECTION 213(a), ARTICLE 31: What included in gross income. 9–20–766 S. 1329

INCOME TAX: REVENUE ACT OF 1916, TITLE I, SECTION 8(e), AS AMENDED BY SECTION 1204 OF THE REVENUE ACT OF 1917.

Where the members of a firm establish a fund by transferring a given sum of money to certain employees in trust, and where such fund is to be invested in the business of the firm and the interest is to be paid annually to a certain class of employees, who hold certificates entitling them to participate in the profits of the fund, such certificates being subject to cancellation at the pleasure of the firm, the income from such fund is taxable as a part of the firm's income.

Opinion is requested as to how the income from an employees' profit-sharing fund is taxable. That part of the Revenue Act of 1916, as amended by the Revenue Act of 1917, which relates to the question now under consideration reads as follows:

SEC. 8(e). 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 title.

The members of a firm entered into an agreement with certain designated employees, who were called managers and trustees. By this agreement a fund was established, which was intended to be the nucleus of a larger one for the benefit of its senior employees.

The sum of x dollars was transferred to the trustees, to be held by them and their successors for the benefit of those who should from time to time be the holders of certain certificates issued to the senior employees. The issuance of the certificates to the employees is evidence of their right to participate in the profits of the fund under the conditions provided for in the agreement. The fund is subject to increase by contributions from the firm and decrease by distribution. No money is paid by the employees for the issuance of the certificates to them, and only the senior employees participate on these terms. The junior employees, it was provided, may, when receiving a gift from the firm, elect to take that gift in certificates. It will, therefore, be seen that the entire fund, both at the beginning and during the continuance of the agreement, derives its principal exclusively from the firm.

The investments are confined to special syndicates, in which the firm is interested, or issues of securities in which the firm deals, and deposits of uninvested funds remain with the firm. The employees are divided into various classes, not necessary to consider, the personnel of these classes being entirely controlled by the members of the firm. No rights, either against the firm or the trustees, accrue to the employees by reason of the agreement, it being specifically stipulated therein that no member of the firm, no successor, and none of the managers assume any liability or any responsibility by reason of the execution and delivery of the agreement. The managers are elected by the votes of the certificate holders. A supplemental agreement was entered into after the outbreak of the war, but its terms do not materially affect the original one.

It will be seen from the facts that the fund is not in any sense a separate enterprise and that the holders of the certificates invest no money. The managers conduct no business, but merely invest the fund in securities designated by the firm. Though the holders of the certificates have power to choose, within certain limitations, the persons who shall act as trustees, and while the certificates held by the employees are, for this purpose, invested with a voting power similar to that of stock, these facts, though possibly somewhat misleading, do not affect the nature of the fund.

It will be observed that the firm reserves the right at any time to cancel any outstanding certificate with or without cause, and its control over the issuance of certificates and the management of the fund is very broad. So broad are its powers of cancellation of certificates that they render the continued existence of the fund dependent on the pleasure of the members of the firm, it being expressly provided that no recourse shall be had or claim or liability be asserted or enforced against the members of the firm or any of them directly or indirectly under the agreement.

The fund is closely identified with the business of the firm, is in fact derived from no other source, and must be held to be a capital investment by the firm. In the second paragraph of the agreement it is stated that the primary object of the fund is to participate in the investment security business of the firm. Throughout the entire agreement the control of the fund by the firm is repeatedly asserted, and it must therefore be concluded that such fund is neither a separate business venture nor an irrevocable trust, but a part of the business of the firm, and therefore taxable in the same manner with other income of the firm. The case is similar to the one under consideration in Solicitor's Memorandum 155.

It is therefore held that where a fund is established by the transfer by a firm to certain employees in trust of a given sum of money, where such fund is to be invested in the business of the firm and the interest is to be paid annually to a certain class of employees who hold certificates entitling them to participate in the profits of the fund, such certificates being subject to cancellation at the pleasure of the firm, the income from such fund is taxable as a part of the firm's income.

SECTION 213(a), ARTICLE 31: What included in gross income.

(See 17–20–883; sec. 201, art. 1544.) Dividends paid in the form of interest-bearing promissory notes.

SECTION 213(a), ARTICLE 31: What included in gross income. 20–20–931 O. D. 501

Damages in the form of yearly payments throughout the life of the injured party, recovered through the compromise of a threatened suit for breach of promise of marriage, are not regarded as a return of capital since the benefits of which the injured party was deprived were merely anticipatory. Such payments are within the statutory definition of income and accordingly are taxable to the recipient.

SECTION 213(a), ARTICLE 31: What included in gross income. 21-20-948 O. D. 512

A taxpayer who had been discharged from the employ of a railroad company was reinstated by order of the railroad board and paid for all time lost during a period of over two years. It is contended that the sum received by the taxpayer, for which he rendered no service, is in reality a gift and not taxable.

Held, that the payment can not be treated as a gift for the reason that it was not made voluntarily. It is income within the ordinary acceptation of the word and not being such income as is expressly exempt under the Act, should be included in the return of the taxpayer for the year in which it was received by him.

SECTION 213(a), ARTICLE 31: What included in gross income. 24-20-997 S. 1384
(Also Section 213(b), Article 72.)

INCOME TAX: SECTION 213(b) 6, REVENUE ACT OF 1918.—EXEMPT INCOME.

The alienation of a wife's affections is not such a personal injury as to entitle the recipient of damages therefor to exemption from income tax to the amount received.

The question is raised as to the status for income tax purposes under Title II of the Revenue Act of 1918, of a sum received by a taxpayer as damages on account of the alienation of the affections of his wife. The provisions of the statute, indicated as bearing on the matter, are as follows:

SEC. 213. That for the purposes of this title * * * the term "gross income" * * *—

(b) Does not include the following items, which shall be exempt from taxation under this title: * * *

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.

The language, "the amount of any damages received whether by suit or agreement on account of such injuries or sickness," taken by itself, would seem to include any personal injury. That alienation of a wife's affections is a personal injury is sufficiently well settled. *Leicester* v. *Hoadley* (Kans.), 71 Pac. 318; *Tinker* v. *Colwell*, 193 U. S. 473, 487. It might, therefore, be held that the sum in question is entirely exempt.

Nevertheless, it appears more probable from the language of subdivision (b)6 of section 213, taken as a whole, referring as it does, to accident and health insurance and workmen's compensation Acts, that the term "personal injuries," as used therein means physical injuries only. This view of the intent of the statute is supported by the history of the legislation. In *Doyle* v. *Mitchell Bros.*, 247 U. S. 179, it was held in effect that funds obtained by the conversion of capital assets and which represented only the actual value of such assets was not taxable income. Applying this decision, the Attorney General held in an opinion, dated June 27, 1918, that the

proceeds of an accident insurance policy were not subject to tax, the conclusion being based upon the reasoning that the human body is a kind of capital and that the proceeds of the insurance policy really represented a conversion of the capital lost through the injury. In Treasury Decision 2747 it was held upon similar principles that an amount received by an individual as the result of a suit or compromise for personal injury sustained by him through accident is not income taxable under the Revenue Acts of 1916 and 1917, respectively. Probably the provision of the Revenue Act of 1918 in question, so far as personal injuries are concerned, is merely declarative of the conclusions thus stated and intended to go no further. These conclusions rest, as stated, upon the theory of conversion of capital assets. It would follow that personal injury not resulting in the destruction or diminution in the value of a capital asset would not be within the exemption. From no ordinary conception of the term can a wife's affections be regarded as constituting capital.

However, even though the alienation of a wife's affections be not regarded as such a personal injury as is contemplated by the statute, it is still possible that damages therefor might be measured in part by sickness resulting therefrom and, of course, the amount received on account of such sickness would be exempt under the express language of the statute. There is, however, nothing in the instant case to indicate that the amount received was in any degree compensation on account of sickness. The proper conclusion seems, therefore, to be that the alienation of a wife's affections is not such a personal injury as to entitle the recipient of damages therefor to exemption.

WAYNE JOHNSON,
Solicitor of Internal Revenue.

SECTION 213(a), ARTICLE 31: What included in gross income. 24–20–998 O. D. 542

A died in 1912, owning certain shares of the common stock of the M Company. Subsequently the company became insolvent and under the plan of reorganization holders of the common stock were required to pay a certain assessment per share. Decedent's estate was unable to meet the assessment and the partnership of which A had been a member advanced the sum called for and underwrote the reorganization. For its services as underwriter the firm received in 1916 y shares of the stock of the reorganized company and x dollars in cash, all of which was turned over to the decedent's estate. Neither the stock nor the cash was entered upon the firm's books and no part thereof was included in the individual returns of the partners.

Held, that since the stock and cash received by the partnership were for services performed by it as underwriter, such compensation represented taxable income for the year 1916, regardless of the fact that no distribution of such funds was made to the individual members thereof, and irrespective of the reason for which the partnership entered into the transaction.

SECTION 213(a), ARTICLE 31: What included in gross income. 25–20–1011 O. D. 552

Benefits received from a labor union by an individual member while on strike are to be included in his gross income for the year during which received, there being no provision of law exempting such income from taxation.

SECTION 213(a), ARTICLE 31: What included in gross income.

(See 26–20–1032; sec. 221, art. 364.) Bond interest paid in scrip.

SECTION 213(a), ARTICLE 32: Compensation for personal services. 2–20–670 O. D. 361

Retiring allowances made to teachers or to widows of teachers by the Carnegie Foundation for the Advancement of Teaching constitute taxable income. (O. D. 361 and O. 560 overruled by L. O. 1040, published in Bulletin 28–20.)

SECTION 213(a), ARTICLE 32: Compensation for personal services. 4–20–700 O. 980
(Also Section 213(b), Article 73.)

BEQUEST TO EXECUTOR CONDITIONED ON HIS PERFORMANCE OF DUTIES AS AN EXECUTOR.

> Where an executor receives a bequest conditioned upon his continuous performance of duties as an executor, such a bequest is deemed to be compensation for his services, although it is expressly additional to the executor's legal commissions.

The claim of A, for the abatement of a portion of the additional income tax assessed against him for 1916, presents the question of whether a bequest received by an executor conditioned on the continuous performance of duties as an executor, and declared to be expressly additional to the executor's legal commission, is exempt from income tax.

Section 4 of the Revenue Act of 1916, provides:

> The following income shall be exempt from the provisions of this title: * * * the value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included as income); * * *.

The will of the decedent provided in part that each year his executors and trustees act as personal representatives of his estate with respect to the M Company, they should receive, in addition to any and all commissions to which they were entitled as executors and trustees, one per cent of the profits of the M Company, for such period as his estate or any trust estate created by his will should enjoy any interest in the M Company as constituted at the time of his decease or thereafter or in any successor firm.

Income tax has been assessed upon this one per centum of the profits of such firm accrued to the claimant, who asks that the tax be abated on the ground that this income is exempt from tax.

So far as the instant case is concerned, there is nothing clearly to show that the bequest to the claimant is anything other than additional compensation paid to him for his services as executor of the estate. The decedent may have considered that the legal commissions allowed an executor were not sufficient compensation for the duties to be performed by his executor, and the bequest may be no more than a provision that his executor shall receive an additional compensation for services, and that that additional amount shall depend in large part upon the value of the services of the executor to the partnership in which the decedent was interested. This view of the case is in line with Law Opinion 409, which held that the specific language of the statute indicating the intention to tax every form of compensation must be deemed to confine exemption of gifts to those which are not in place of compensation or payment of any sort.

SECTION 213(a), ARTICLE 33: Compensation paid other than in cash. (Also Section 202, Article 1561.) 1-20-656 O. 962

INCOME TAX: SECTION II-B OF THE ACT OF OCTOBER 3, 1913.

Stock, based upon a new and untried invention, received in payment for services rendered is income to the person receiving such stock to the extent of its market value. The market value at the time of receipt is to be fixed by taking into consideration the first prices such stock brought when placed on sale within a reasonable time after such receipt, due allowance being made for intervening circumstances affecting such value.

The question upon which opinion is requested is whether certain shares of stock and certain voting trust certificates received by a taxpayer as payment for services rendered in 1915 should be considered income for that year; and, if so, to what extent.

Section II-B of the Act of October 3, 1913, provides:

* * * The net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid * * *.

It being an entirely new venture, the market price for the stock at the time of the incorporation and the issuance of stock was not known. Shortly thereafter, the taxpayer, as a part of the agreement, proceeded to make a market for the stock. That is to say, he had it listed on the curb and arranged for bringing it to the attention of the public. For his services the taxpayer received in payment shares of the stock of the corporation and voting trust certificates (non-negotiable).

No stipulated cash value appears to have been placed on the taxpayer's services.

Where services are paid for in something other than money, the fair market value of the thing taken in payment is the amount to be included as income. If stock of a corporation is received in payment for services rendered, such stock must be considered as equivalent to

cash, providing it has any actual money value. It is to be treated as if the corporation sold the stock for its market value and paid the employee in cash. (See art. 33 of Regulations 45.) To constitute taxable income, however, the value of the stock received must be so fixed as to be capable of measurement at the time of receipt. If its value can not be measured in terms of cash or money's worth, then it can not be considered income for income tax purposes. (19–19–494, page 40, Cumulative Bulletin, December, 1919.)

The value of stock which has no market price may be estimated by resort to the value of the assets capitalized and attendant circumstances which may affect the value of such assets. (*Goodwin* v. *Wilbur*, 104 Ill. App., 45; *Collins* v. *Denny*, 89 N. W., 1012; *Virginia* v. *West Virginia*, 238 U. S., 202.) In the case of inventions, their value is dependent upon proven utility or the likelihood of practical usefulness and therefore stock issued thereon will have a corresponding value. If an inventor should sell a recently patented invention to a manufacturer before its use has been tested, but simply upon its apparent usefulness, it may be said that the invention at that time is worth what is paid for it, because a price has been offered and paid. The measure of value is the price paid. (*Burke Hollow Coal Co.* v. *Lawson*, 151 S. W., 657; *Johnson-Brinkman Commission Co.* v. *Wabash R. Co.*, 64 Mo. App., 590.) Stock issued upon such invention would be worth the value of the invention, measured by the price which the manufacturer has paid for it.

Where the inventor himself forms a company and issues stock upon his invention and there are dealings in said stock at or within a reasonable time after the issuance thereof, prices then paid may be said to be evidence of the value of the invention capitalized and therefore of the stock at the time of its issuance. This is upon the principle that a subsequently existing fact is evidence of some probative value of the prior existence of the same fact. (See *Humphreys* v. *Minnesota Clay Co.*, 103 N. W., 338; *Atwood* v *Bears*, 8 N. W., 55.)

The taxpayer has received something which he did not have before. If what he has received is of value and that value is capable of measurement, he has received income. (19–19–494, supra.) The fact that the stock received sold in the open market within a very short time after the date of its issue and receipt by the taxpayer is strong evidence that it had value at such date and the prices received in such sales are evidence of the measure of its value within the principles above laid down. However—

> In the case of subsequent existence as evidence at the time in issue, there is the disturbing contingency that some circumstance operating in the interval may have been the source of the subsequent existence, and the propriety of the inference will depend on the likelihood of such intervening circumstance having occurred and been the true origin. (Sec. 437, Wigmore on Evidence. See also *Doll* v. *Hennessy Merc. Co.*, 81 Pac., 625.)

Consequently, even though the inference is strong that the first prices brought in the sale of the stock in question represent its true market value at the date of issue and receipt by the taxpayer, still the activities of the taxpayer in bringing the stock to the attention of the public in a favorable light might have been the cause for a large portion of the prices so received. Such activities can not, however, be said to account for all of such prices. It is therefore fair

and reasonable to conclude, in view of the range of prices over a period of two years, that the price received over and above the stated par value was due to the taxpayer's efforts at publicity, and that the value of the stock when received by him was its par value. (See *Moffitt* v. *Hereford*, 34 S. W. (Mo.) 252.)

For the purposes of this opinion, the voting trust certificates received by the taxpayer are to be considered on the same footing as the stock delivered outright. He was indeed the beneficial owner of the stock they represented and received them as such, and hence any value they had inured to him.

It is therefore held, in the peculiar circumstances of this case, that stock, based upon a new and untried invention, received in payment for services is income to the person receiving the stock to the extent of its market value. The market value at the time of receipt is to be fixed by taking into consideration the first prices brought for such stock when placed on sale within a reasonable time after such receipt, due allowance being made for intervening circumstances affecting such value.

SECTION 213(a), ARTICLE 33: Compensation paid other than in cash.

(See 12–20–793; sec. 213(b), art. 71.) Premiums paid by employer on group life insurance covering lives of employees.

SECTION 213(a), ARTICLE 33: Compensation paid other than in cash. 13–20–819 T. D. 2992

Article 33 of Regulations 45 is hereby amended to read as follows:

ART. 33. *Compensation paid other than in cash.*—Where services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair value of the compensation received. Compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash. When living quarters such as camps are furnished to employees for the convenience of the employer, the ratable value need not be added to the cash compensation of the employee, but where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax. Premiums paid by an employer on policies of group life insurance covering the lives of employees, the beneficiaries of which are designated by the employees, are not income to such employees.

SECTION 213(a), ARTICLE 38: Gross income of farmers.

(See 18–20–893; sec. 212, art. 23.) Treatment of opening inventory of farmers when changing from cash to accrual basis.

SECTION 213(a), ARTICLE 41: Sale of good will.

(See 10–20–777; sec. 202, art. 1561.) Methods of determining value of intangible assets as at March 1, 1913.

SECTION 213(a), ARTICLE 42: Sale of personal property on installment plan. 13–20–806 S. 1353

The treatment outlined in article 42 of Regulations 45 for sales of personal property on the installment plan is not limited to dealers alone, or to sellers of chattels as distinguished from sellers of other forms of personal property, such as corporate stock. The retention of a lien upon the property sold as security for the purchaser's agreement to pay, does not alter this conclusion.

SECTION 213(a), ARTICLE 42: Sale of personal property on installment plan. 18–20–894 O. D. 482

For the purpose of the income tax, sales of real or personal property on the installment or deferred payment plan, as described in articles 42 to 46 of Regulations 45, shall be treated as therein provided, regardless of whether the sale is made by a dealer or other individual.

SECTION 213(a), ARTICLE 46: Deferred payment sales of real estate not on the installment plan. 11–20–784 O. D. 409

A sold to B real estate which was mortgaged to secure a loan made by a State. B agreed to make payment, partly in cash, assume payment of the mortgage held by the State, and give A a mortgage to cover the balance of the sale price. Notwithstanding that the State will not accept B's promise to pay in lieu of A's original note and mortgage, thus leaving A liable for payment of the note in case B defaults it is held that A has received the full amount of the sale price in cash or its equivalent and should report the entire profit realized as income for the year in which the sale was consummated.

SECTION 213(a), ARTICLE 47: Annuities and insurance policies. 4–20–701 O. D. 379

The basis for ascertaining the taxable income resulting from the disposition of a life insurance policy acquired prior to March 1, 1913, where the insured transfers the policy to some one other than the insurance company, which wrote the policy, is the cash surrender value of the policy as at March 1, 1913. However, if the insured surrenders his policy and all his rights thereunder to the insurance company, which wrote the policy, the aggregate amount of the premiums paid during the period the policy was held, or the cash surrender value of the policy as at March 1, 1913, whichever is greater in amount, is to be taken as the basis in computing the taxable income derived by the insured.

SECTION 213(a), ARTICLE 48: Rent and royalties.

(See 3–20–689; sec. 214(a) 3, art. 133.) Assessments for local benefits paid by tenant for landlord.

SECTION 213(a), ARTICLE 49: Compensation for loss. 21–20–949 O. D. 513

Articles 49 and 50, Regulations 45, provide that in cases where an owner of property has lost or transferred title to it by reason of the exercise of the power of requisition or eminent domain, and proceeds immediately in good faith to replace the property, or where it is not practicable to immediately replace same and application is made to establish a replacement fund, the gain which is to be included in gross income is measured by the excess of the amount received as compensation or reimbursement over the amount actually and reasonably expended to replace the property substantially in kind.

The provisions of these two articles are applicable to property used for residential or farming purposes.

SECTION 213(a), ARTICLE 50: Replacement fund for loss.

(See 12–20–801; sec. 326, art. 837.) Replacement fund for lost steamers derived from insurance collected; relation to invested capital.

SECTION 213(a), ARTICLE 52: When included in gross income. 2–20–671 A. R. R. 13

REVENUE ACT OF 1918, SECTION 213(a).

Gross income from an executory contract for purchase and sale of real estate.

If a contract to sell real estate is executed in 1917, there being a small cash consideration at the time of execution, and the delivery of the deed and transfer of possession take place in 1918, pursuant to the contract, in which year a substantial payment is made, notes being given secured by mortgage for unpaid balance, the profit from the transaction should be reported as gross income for 1918.

The question in this case is whether income is deemed to have arisen as of the year in which a contract to sell real estate was executed or as of the subsequent year in which the real estate was conveyed and possession was transferred pursuant to the contract.

In October, 1917, A entered into an agreement with B for the conveyance of real estate on March 1, 1918. A small portion of the purchase price was paid when the contract was signed. A substantial payment was made at the date of conveyance and the balance of the purchase price was secured by a mortgage.

This is a sale in which real estate is to be conveyed for a consideration consisting of cash and of credit secured by a mortgage. A sale contemplates the substitution of one asset for another asset. A taxable profit is derived by the vendor, if the new asset is of greater value than the cost, or value on March 1, 1913, if acquired prior thereto, of the asset it replaces. Accordingly, the determination of the time of realization depends upon when there has been the substitution of assets contemplated by the sale of the property.

Because of the right of specific performance, the courts hold that from the execution of the contract the vendor's interest constitutes

personalty and is distributable among his next of kin. (*Mayer* v. *Gowland*, 2 Dick. 563, Eng. 1779; and cases cited in 57 L. R. A. 646.) Conversely it is held that the vendee's interest constitutes realty and descends to his heirs. (*Milner* v. *Mills*, Mosely, 123, Eng. 1729; and cases cited in 57 L. R. A. 646.) It is also held that the wife of the vendee is entitled to dower in land purchased under an executory contract (*Thompson* v. *Thompson*, 45 N. C. 430), and that the wife of the vendor is not entitled to dower in property which he had agreed to sell prior to marriage, although he held the legal title after marriage. (*Dean's Heirs* v. *Mitchell's Heirs*, Ky. 1830, 4 J. J. Marshall, 451.) It is also held that the statutory homestead right attaches to land held by the buyer under an executory contract of sale and purchase. (15 American and English Encyclopedia second edition, 561.) These cases indicate that so far as rights depend upon the distinction between real estate and personal property the interest of the vendee becomes real estate and the interest of the vendor becomes personal property from the execution of the contract of purchase and sale even though payment of the purchase price, delivery of the deed, and the transfer of possession be postponed.

In many cases the courts have decided that the risk of loss during the period between the execution of the contract and the time set for performance should fall on the owner of the property, but there is some dispute as to which party should be considered owner. The great majority of the courts hold the vendee to be the owner, and the risk of loss of buildings by fire and similar losses must be borne by him and not by the vendor. Conversely the vendee is entitled to any increment in value. (*Payne* v. *Meller*, 1801, 6 Ves Jr. 349; *Rayner* v. *Preston*, 1881, L. R. 18 Ch. Div. 1.) The American cases are collected in 39 Cyc. 1641 and 27 L. R. A. (N. S.) 233. A few jurisdictions held that the loss falls on the vendor. (*Thompson* v. *Gould*, Mass. 1838, 20 Pick. 134.) The Iowa cases follow the majority rule. (*Johnstone* v. *Robertson*, Iowa, 1917, 162 N. W. 66; *Wolfe* v. *Iowa Railway and Light Co.*, Iowa, 1915, 155 N. W. 384; *Frost* v. *Clark*, 1891, 82 Iowa, 298, 48 N. W. 82; *Shesby* v. *Scott*, 1905, 128 Iowa, 551, 104 N. W. 1139.) Hence, with reference to the most important attribute of ownership, the courts hold that from the execution of the contract the vendee is the owner of the real estate, and the vendor is no longer the owner.

The courts also hold that the vendee's interest can be sold or mortgaged and can be levied on and sold on execution. (*Simonson* v. *Wenzel*, 147 N. W. 804; *Ralon* v. *Mercier*, 42 N. W. 66; *Cummings* v. *Duncan*, 134 N. W. 712; 39 Cyc. 1662, 1676.) The vendor retaining title as security has often been compared to a mortgagee or a trustee. The vendee has been held entitled to describe himself in an insurance policy as the "sole owner" or the "unconditional owner" or the "owner in fee simple." The vendee is commonly regarded as the owner under the mechanic's lien laws. Note, Ames Cases in Equity Jurisdiction, page 240. Generally in this country the vendor is not entitled to retain the part of the purchase money paid by the vendee and keep the property, but must obtain a decree for foreclosure by sale of the property. Note, Ames Cases in Equity Jurisdiction, page 226. In no case do these decisions depend upon transfer of possession of the property. Note, Ames Cases in Equity Jurisdiction, page 236.

The law, then, is that from the execution of an executory contract of sale and purchase of real estate the vendee is regarded as the owner of the property and is clothed by the courts with the benefits and burdens of ownership and is entitled for most purposes to designate himself as owner. The legal title retained by the vendor is a bare legal title held by him as security for the unpaid purchase price, and his interest is like that of a trustee or mortgagee of real estate. The only incident of beneficial ownership to which the vendee is not entitled is the rents and profits which a vendor rightfully retaining possession is entitled to. (*Iowa Railroad Land Co.* v. *Boyle*, 134 N. W. 590.) But to offset this the vendor remaining in possession must pay the taxes and current expenses and is not entitled to interest on the unpaid purchase price. (43 L. R. A., N. S., 51.)

These cases, however, do not approach the question from a commercial standpoint, but approach it entirely from the standpoint of the technical equitable doctrine of specific performance. The courts have not in the past been concerned with questions as to the realization of gain or loss through the sale of real estate. To such a question it is believed that different principles are applicable and that the question should be decided from a commercial standpoint. During the period between October, 1917, and March 1, 1918, "A," the vendor, had the legal title, the right of possession, and the right to the rents and profits which might arise out of this property. It is to be noted that an action for specific performance would not have put the vendee in possession during 1917, because he was not under the contract entitled to possession; nor was any negotiable instrument executed and delivered during 1917. For the vendee to execute such an instrument before possession or deed is secured would be unusual. Under these circumstances commercial usage does not sanction the conclusion that a substitution of assets had taken place prior to 1918, and the Government is not warranted in treating the whole profit as realized.

The Committee, therefore, recommends that the income arising out of this transaction be taxable as for the year 1918 under the income tax and not for the year 1917 under the income tax and possibly the excess profits tax. The advance payment is to be regarded as a return of capital, and, assuming it to be less than the cost, no part of it is subject to income or profits tax for the year 1917. No opinion is expressed as to the result if the taxpayer received negotiable instruments commercially equivalent to cash in a year prior to the year in which possession was to be delivered and deed was to pass.

SECTION 213(a), ARTICLE 52: When included in gross income. 3–20–683 T. D. 2960

INCOME TAX—DECISION OF COURT.

Jackson v. *Smietanka.*

[UNITED STATES DISTRICT COURT, DECEMBER, 1919.]

A taxpayer who keeps no books of account, and to whom is paid, upon the termination of services extending over a period of years, a lump sum in amount not previously agreed upon, as compensation for such services, must return as income in the year in which re-

ceived the entire amount so paid him, even when such payment is accompanied by a statement proportioning the compensation over the years in which the services were rendered.

The appended decision of the United States District Court for the Eastern Division of the Northern District of Illinois, in the case of *Jackson* v. *Smietanka*, is published not as a ruling of the Treasury Department, but for the information of internal revenue officers and others concerned. (January 7, 1920.)

IN THE UNITED STATES DISTRICT COURT,
EASTERN DIVISION OF NORTHERN DISTRICT OF ILLINOIS.

William J. Jackson versus Julius F. Smietanka, Collector of the United States Internal Revenue, First District of Illinois—No. 33109.

PAGE, Circuit Judge: This is a demurrer to the declaration.

The sole question involved in this case is, was plaintiff erroneously taxed under the Revenue Law of 1918, or should he have been taxed under the several laws of the years 1913 to 1918, as plaintiff contends, on an income received as follows:

Plaintiff was on May 27, 1913, appointed a receiver of the Chicago & Eastern Illinois Railroad Co., and served until April 27, 1918, for which he received, under the order of the district court dated August 4, 1913, $2,000 per month commencing July, 1913, to be received on account, with the liberty on his discharge to apply for further compensation. When he resigned a general order was entered, on April 27, 1918, allowing him an additional compensation of $100,000. That general order was amended by order of April 22, 1919, as follows:

"That said services of said William J. Jackson as receiver were rendered continuously from May 27, 1913, to and including April 27, 1918, and the compensation therefor now allowed was earned and accrued as follows: In the year 1913, $12,144.85; in the year 1914, $20,334.26; in the year 1915, $20,334.26; in the year 1916, $20,334.26; in the year 1917, $20,334.26; in the year 1918, $6,518.11."

That amendment was entered as of April 27, 1918. The petition for the amended order was filed and the order made long after the tax was assessed. The Government was not a party thereto.

Plaintiff cites section 206 of the Revenue Law of 1918 as a basis for his contention, and says, "If that section can not reasonably be applied to such a case as that of plaintiff, we ask to what sort of a case it does apply." Article 1641 of Treasury Department Regulations 45, under the Revenue Act of 1918, says that section 206 refers to other and wholly different matters, and this interpretation is supported, and in the opinion of the court conclusively, by sections 201 and 205 of the same Act, in the former of which direct reference is made to said section 206.

After specifying in detail what the gross income includes, section 213 provides: "The amount of all such items shall be included in the gross income for the taxable year in which *received* by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period."

Subdivision (b) of section 212 provides: "The net income shall be computed upon the basis of taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer."

Plaintiff kept no books, so that clause does not apply. It further provides that: "If no such method of accounting has been so employed or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner *as in the opinion of the Commissioner does clearly reflect the income.*"

The only language which might apply to plaintiff is: "If no such method of accounting has been so employed * * * computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income."

This seems to leave the burden upon the plaintiff here to show that the method of accounting insisted upon by him has been prescribed as a basis by the Commissioner.

Article 52 of Regulations 45 provides: "Gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included when they accrue to him in accordance with the approved method of accounting followed by him."

Article 32 of said Regulations 45 states: "Where no determination of compensation is had until the completion of the services, the amount received is income for the calendar year of its determination."

The demurrer is sustained.

SECTION 213(a), ARTICLE 52: When included in gross income. 6–20–725 S. 1315

INCOME TAX—SECTION II, PARAGRAPH B, ACT OF OCTOBER 3, 1913; SECTION 2(a), REVENUE ACT OF 1916.

Where a sale is made and because of claimants for commissions the seller is required by the purchaser to put a certain part of the purchase price in escrow, and thereafter certain claimants are paid directly out of said funds in escrow, the seller is not liable for income tax upon any part of the purchase price in escrow until actually received by him.

SECTION 213(a), ARTICLE 52: When included in gross income. 8–20–750 S. 1335

INCOME TAX—REVENUE ACT OF 1918, SECTIONS 213 AND 233.

The award in the year 1918 by a board of arbitration of x dollars to the M Company on its unliquidated claim to a portion of the proceeds arising out of transactions which took place in 1917 is income to the corporation for the year 1918 rather than 1917.

The question has been asked as to whether the income arising from transactions occurring in 1917 and which was awarded to the M Company by a board of arbitration in 1918 is taxable income for the year 1917 or 1918.

Section 233 of the Revenue Act of 1918 provides in part:

(a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in section 213. * * *

Section 213 of that Act provides in part:

That for the purposes of this title (except as otherwise provided in sec. 233) 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, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period: * * *

All the stock of the M Company is owned by B, C, and D. Whenever merchandise was bought in bulk by the taxpayer corporation,

parts of the lots were occasionally rejected as worthless. On such occasions, C, individually, would buy the rejected lots and have it stored on a part of the ground occupied by the taxpayer, set aside for that purpose. The buying of these lots rejected by the M Company continued until C had accumulated a large quantity. In 1917, due to the unusual demands of the war, this accumulation had become very valuable, and during that year the M Company, at the direction of C, sold the greater part of the same and took over on its own account the small part remaining. The proceeds of these sales were credited on the books of the M Company to the N Company and to the O Company, trade names under which C did business. In making the sales above referred to in 1917, C made use of the facilities of the M Company and, because of this fact, the M Company claimed for itself a part of the proceeds of the sales. An agreement with C as to the amount due the M Company could not be reached during 1917, and it was decided to submit the matter to a board of arbitration. This was done in 1918, and in that year the board of arbitration decided that the dealings between C and the M Company should be treated as partnership transactions, and awarded to each one-half of the proceeds of the sales, or x dollars. The x dollars awarded the M Company was included in its return for 1918, but the revenue agent in charge believes that this item should be returned by the corporation for 1917, as the corporation keeps its books on an accrual basis, and the income arose from transactions which took place in 1917. If the corporation is required to include this item in its return for 1917, a loss will be shown in its return for 1918.

It has been uniformly held by this office that a person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor, rendered in a latter year would be income in that year, assuming that it would have been income in the earlier year if then received. (Art. 52, Reg. 45. See also Holmes, Federal Taxes, p. 405; Black, Federal Taxes, sec. 50.) An award by a board of arbitration is nowise different than a judgment in this respect. (*Olston* v. *Oregon Water Power Co.*, 52 Oreg. 343, 97 Pac. 538; *Alexander* v. *McNeal*, 28 Fed. 403.)

In the case of *William J. Jackson* v. *Julius F. Smietanka*, collector, case No. 33109, recently decided in the United States District Court, Eastern Division of the Northern District of Illinois, the court had before it a similar question. In that case, Mr. Jackson had been appointed in 1913 to act as a receiver of a certain railroad company at a fixed compensation of $2,000 a month, and with the added privilege to apply for additional compensation at the time of his discharge. The receiver was discharged in 1918 and the court at that time awarded him $100,000 additional compensation. The Bureau of Internal Revenue required him to return this amount as income for 1918, and the plaintiff brought suit to recover the taxes paid under protest. In passing upon the demurrer entered to the plaintiff's complaint, the court held that the entire amount was income to the plaintiff for 1918 on the theory that prior to that time the plaintiff could not be sure that he would receive any additional compensation. (See also *Edwards* v. *Keith*, 231 Fed. 110.)

In passing upon whether commissions received in 1913 by an insurance agent on account of renewal premiums paid on policies

that were income of the agent for 1913, the court in *Wood* v. *Lewellyn* (252 Fed. 106) said (p. 108):

> No doubt they (commissions) were earned by work done and money spent in the earlier years; the agent's work was complete when he obtained the application and the society issued the policy; his right to commissions on future renewals came then into being, and he himself was required to do no more. He had earned his pay and had received a part of it; to the rest he then acquired a right, such as it was, but no determination could then be made how much the rest would be * * * Although the right had value, it lacked an essential element; no renewal premium might ever be paid, in that event he would receive nothing more.

Prior to the award of the board of arbitration the M Company could not be sure that it would receive anything from the proceeds of the sales. Negotiations between the parties during 1917 on this matter were without results; there was no amount agreed upon in that year which could have been accrued on the books of the M Company. The outcome of the entire controversy was so uncertain that it could not possibly have been foretold. This is clearly indicated by the fact that the taxpayer corporation credited in 1917 the entire amount of the sales to the trade names under which C was doing business. (Compare with Solicitor's Memoranda 726 and 983.)

It is therefore held that the award in the year 1918 by a board of arbitration of x dollars to the M Company on its unliquidated claim to a portion of the proceeds arising out of transactions which took place in 1917 is income to the corporation for the year 1918 rather than 1917.

SECTION 213(a), ARTICLE 52: When included in gross income. 8-20-751 O. 988

No realization of gain or loss arises from a mere contract to sell real estate in the future. The sale is held to occur at the time a deed passes or at the time possession and the burdens and benefits of ownership are from a practical standpoint transferred to the buyer, whichever occurs first. Payments made prior to the sale are to be applied in reduction of cost so far as they do not exceed cost; being treated as income to the extent, if any, to which cost is exceeded.

SECTION 213(a), ARTICLE 52: When included in gross income. 14-20-824 O. D. 432

If the compensation of a Federal official has been withheld for a number of years pending settlement of a contested election, and it is paid to him after a decision has been rendered in his favor, the entire amount should be reported as income of the year in which received.

SECTION 213(a), ARTICLE 52: When included in gross income.

(See 15-20-850; sec. 218, art. 334.) Income of stockholder for calendar year when personal service corporation changes from fiscal to calendar year basis of filing returns.

SECTION 213(a), ARTICLE 52: When included in gross income. 16–20–858 O. D. 460

A performed certain services in 1909 under an agreement that he was to receive as compensation a percentage of the net income of a business enterprise, the time of payment, however, to be within the discretion of the individuals in control of the business enterprise. The amount of A's compensation was determined in 1916 but not paid until 1919. Held, that as A kept his books on the cash receipts and disbursements basis, the entire amount received constitutes income for the year 1919.

SECTION 213(a), ARTICLE 52: When included in gross income. 16–20–874 O. D. 461
(Also Section 201, Article 1548.)

A corporation assigned its principal asset, a mortgage, to trustees in trust for its stockholders and then instituted liquidation proceedings. The mortgage was payable in annual installments with interest and the beneficiaries under the trust were to receive proportionate shares of the principal and interest as paid to the trustees. The trustees were to receive compensation in a fixed amount plus a percentage of the income received and distributed, and be reimbursed for expenses incurred in connection with the trust.

Held, that the profit of the stockholders from the surrender of their stock is not definitely ascertainable, and they need not report any amount as income until the total sum received in liquidation exceeeds either the cost of their stock or its fair market value March 1, 1913, if acquired prior to that date.

SECTION 213(a), ARTICLE 52: When included in gross income. 19–20–910 O. D. 490

A taxpayer took out an insurance policy on the tontine plan in 1902 and in 1917 received the total accumulated dividends. The face value of the policy will be paid to him in 1922, if living.

Held, that the amount received in 1917 was not required to be reported as income for that year. The excess of the amount received at maturity of the policy plus all dividends received thereon, over the total premiums paid prior to March 1, 1913, or the cash surrender value of the policy as of that date, whichever is greater, plus the premiums paid on or after March 1, 1913, will represent taxable income to be reported for the year in which received for both normal and additional tax purposes.

SECTION 213(a), ARTICLE 52: When included in gross income.

(See 19–20–917; sec. 214(a) 1, art. 107.) Bonuses for 1916 made available to recipients during 1919.

SECTION 213(a), ARTICLE 52: When included in gross income. (Also Section 252, Article 1032.) 23-20-984 A. R. M. 56

REVENUE ACT OF 1916.

In re action which should be taken upon the claim of B for the abatement of a portion of the additional individual income tax for 1916 assessed as a result of an investigation of his returns for 1914, 1915, and 1916 by a revenue agent.

The facts upon which the assessment for 1915 appears to have been based are as follows:

B was vice president of the M Company and owned certain shares of its stock, standing in the name of his wife. In 1915 Messrs. A, B, and C, president, vice president, and secretary-treasurer, respectively, of the M Company, entered into a written agreement with the N Company for the sale and delivery to it of certain shares of the M Company's stock at an agreed price per share. Under the terms of this agreement this stock was to be placed in escrow with the O Company for delivery to the purchaser upon payment of the purchase price, which it was agreed should be paid in January, 1916. Subsequently, on account of certain alleged claims and rumors of injunctions to restrain the carrying out of this agreement, the buyers and sellers reached a supplemental agreement to close the sale and deliver the stock immediately, and in December, 1915, a written agreement to that effect was made and executed. Under this supplemental agreement the stock was, in December, 1915, transferred to the N Company and new certificates were issued in the name of the N Company and were held by the O Company as security for the payment of three drafts drawn on the same date by A, B, and C in favor of themselves, payable in 19 days and accepted by the purchaser. A further agreement had been entered into between the parties by which, in lieu of cash, certain shares of the N Company were to be accepted by the sellers in payment for their stock, but that agreement is not material to the issue.

While, of course, the first agreement contemplated that the transaction should be completed in January, 1916, the second and supplemental agreement, by express terms, contemplated immediate closing of the transaction, and in the opinion of the Committee the transfer of the stock and the drawing of drafts by the parties mentioned, which were accepted by the purchaser, constitute a closed and completed transaction as of the date of such transfer and acceptance.

Two other questions are raised—one relating to a payment by the N Company of $17x$ dollars to A, B, and C in consideration of their agreement not to engage within the limits of the United States in the conduct of a similar business within a period of five years without the consent of the company. A asserts that of this amount it was the intention of the parties that $5x$ dollars should be paid to each of the three officers, and that x dollars be paid to the employees of the M Company and x dollars to the sales manager of said company for the purpose of securing their good will, as it was proposed to continue the sales manager and other employees in the service of the purchasing company.

No mention is made of the allocation of this $2x$ dollars to such parties in the written agreement, but if it is established satisfactorily that such was the purpose and that in pursuance of an understanding, oral or written, that this amount was not for the personal benefit of the three men named but for the purpose stated and was not in fact received by A, B, and C for their own benefit, neither the $2x$ dollars nor any part thereof should be included in the income returns of these men.

The third question presented is whether or not the fact that an additional assessment of taxes due for 1915 is barred by the statute should have any bearing on the claim for abatement of 1916 taxes. In the opinion of the Committee it should not. While the law provides that no sums may be paid from the Treasury to any person indebted to the United States, this provision of law does not apply to the abatement of taxes erroneously assessed for any year, and the Government should pursue its remedy of a suit for the recovery of any amounts due in 1915, as it is clearly not justified in collecting taxes for 1916 which are not due for that year.

SECTION 213(a), ARTICLE 52: When included in gross income. 25–20–1012 A. R. R. 124

Suit was brought by the stockholders of a corporation in 1917 to compel the corporation to distribute accumulated cash surplus, as a result of which the court ordered the distribution made, with interest from the date of the decree. The corporation took no steps to comply with this order, and no dividend was declared and no amount made available to the stockholders, but in lieu of such action the company appealed the case. The judgment of the lower court was not affirmed by the higher court until February, 1919, at which time the amounts in question were distributed to the stockholders.

Held, that it was not until the affirmation of the judgment of the lower court by the higher court in 1919 that any amounts became available to the stockholders as income; consequently the amount of such distribution must be reported by the stockholders in their individual returns for 1919, and not in amended returns for 1917.

SECTION 213(a), ARTICLE 54: Examples of constructive receipt. 15–20–842 O. D. 446

A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. Therefore an amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit and should be so reported by the shareholder.

In cases, however, where the amount paid in by the shareholder and the accumulative profits do not become available to the shareholder until the maturity of a share, the proceeds of any share subscribed for on or after March 1, 1913, in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share.

If the subscription was made prior to March 1, 1913, and under the rules of the association the share subscribed for had a cash surrender value on March 1, 1913, and any year thereafter in excess of the amount paid in by the shareholder, the determination of any profit realized at the time of cash surrender or for the year of the maturity of the share will be based on the proceeds in excess of the cash surrender value as of March 1, 1913, plus the aggregate amount paid in subsequent thereto.

SECTION 213(b).—GROSS INCOME DEFINED: EXCLUSIONS.

SECTION 213(b), ARTICLE 71: What excluded from gross income. 12-20-793 O. 1014
(Also Section 213(a), Article 33.)
(Also Section 215, Article 294.)

Premiums paid on policies of group life insurance covering the lives of employees, the beneficiaries of which are designated by the employees, are not income of such employees. Law Opinion 528 modified.

The question is raised whether the premiums paid on policies of group life insurance, carried by an employer upon the lives of employees, the beneficiaries of which are designated by the employees, are income to such employees.

The amounts for which the lives of the individual employees are insured under these policies vary according to the length of time the employee has been in the service of the employer and the contract made by the employer, and generally the entire amount of the premiums under such policies are paid by the employer.

In Law Opinion 528 it was held:

Premiums paid by a corporation on policies of life insurance on the lives of its employees running in favor of the insured, or their heirs, are, if reasonable in amount, clearly a legitimate expense of the corporation, being in the nature of additional compensation to the employees, and are deductible by the corporation in determining its net income for taxable purposes, unless there be some statutory prohibition against allowing such as a deduction. Such additional compensation should, of course, be treated by the employees receiving the benefit of it as a part of their respective individual incomes.

The dictum in this opinion that—

such additional compensation, should, of course, be treated by the employees receiving the benefit of it as a part of their respective individual incomes

was a necessary corollary of the ruling that the—

premiums paid * * * are * * * clearly a legitimate expense of the corporation, being in the nature of additional compensation to the employees.

It is readily possible to consent in the conclusion of the above opinion without concurring in the reasoning by which it was supported. The assumption that in order to constitute a deductible expense on the part of a corporation the premiums paid must be in the nature of compensation to the employees does not appear to be well founded. The deduction allowed by section 214(a) 1 and by section 234(a) 1 is "all the ordinary and necessary expenses." What constitute "ordinary and necessary expenses" varies not only with the nature of the business done but also with the conditions

prevailing in the business generally, so that "ordinary and necessary expenses" at one time may easily include expenses which at another time were clearly not included. That the term includes more than the cost of equipment, material, and labor is recognized in the regulations heretofore promulgated by the Bureau. In article 108 of Regulations 45, it is said:

> Amounts paid for pensions to retired employees or to their families or others dependent upon them; or on account of injuries received by employees, and lump-sum amounts paid as compensation for injuries, are proper deductions as ordinary and necessary expenses.

And in article 562 of the same regulations it is said:

> Donations made by a corporation for purposes connected with the operation of its business, when limited to charitable institutions, hospitals, educational institutions, conducted for the benefit of its employees or their dependents, are proper deductions as ordinary and necessary expenses. Donations which legitimately represent a consideration for a benefit flowing directly to the corporation as an incident of its business are allowable deductions from gross income.

It does not necessarily follow, however, that such expenditures are income to the employees.

The Century Dictionary and Cyclopedia defines "income" as "that which comes in to a person as payment for labor or services rendered or as gain from land, business, or investment of capital;" and in *Stratton's Independence* v. *Howbert*, 231 U. S., 399, 415, it was said, "'Income' may be defined as the gain derived from capital, from labor, or from both combined."

The financial benefits under these policies do not move to the employees personally, but only to their heirs or dependents after their deaths, and the payment of the amount of the policy is, in any case, contingent upon the employee's continuance until death in his present employment which may be terminated at any time, either by himself or by his employer, and upon the continued payment of the premiums by the employer. The employee has no option to take the amount of the premiums paid for the policy covering his life instead of the insurance. The policy has no paid-up value either to the employer or the employee. Such insurance creates no debt on the part of the employer, pays no debt to the employee, and discharges no legal obligation resting upon the employee. The premium paid therefor is in no sense "gain derived" or realized or capable of being realized by the employee in dollars and cents, but only in the feeling of contentment that provision has been made for dependents. It is paid by the employer not as compensation to the employee, but as an investment in increased efficiency. It is therefore not income to the employee.

The fact that in some cases a portion of the premiums paid for group life insurance is paid by associations of the employees, in the absence of any contract between the employer and his employees, does not appear to detract from the force of these considerations or to render a different conclusion necessary in such cases.

It is therefore concluded that while premiums paid for group life insurance constitute proper deductions under the head of "ordinary and necessary expenses," in computing the net income of an employer, whether individual or corporation, they do not constitute additional compensation to the employees whose lives are insured

and are, therefore, not required to be returned as income by such employees.

Law Opinion 528 is hereby modified to conform to this holding.

SECTION 213(b), ARTICLE 71: What excluded from gross income. 21–20–950 O. D. 514

"Supper money" paid by an employer to an employee, who voluntarily performs extra labor for his employer after regular business hours, such payment not being considered additional compensation and not being charged to the salary account, is considered as being paid for the convenience of the employer and for that reason does not represent taxable income to the employee.

SECTION 213(b), ARTICLE 72: Proceeds of insurance. 10–20–778 O. 995

Where under a life insurance policy there is payable to a first beneficiary named 6 per cent per annum of the face value of the policy during life and, upon the death of the first beneficiary, the face value of the policy is payable to a second beneficiary, the payments to the first beneficiary are a part of the proceeds of the policy within the meaning of section 213(b) 1 of Revenue Act of 1918, and are not to be included in gross income for the purpose of the income tax.

The question is raised whether under a life insurance policy providing for the payment to a first beneficiary of 6 per cent per annum of the face value of the policy and, upon the death of the first beneficiary, for the payment to a second beneficiary of the face value of the policy, the amount payable to the first beneficiary is taxable as income to the recipient.

Section 213 of the Revenue Act of 1918 provides:

That for the purpose of this title (except as otherwise provided in section 233) the term "gross income" * * *

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured: * * *

The only question here involved is whether the payments to the first beneficiary are a part of the "proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries." In connection with this question two things are material to be considered: (1) The rate of annual income payable to the first beneficiary is materially greater than that paid by conservative institutions handling investments; and (2) it is expressly stipulated in the policy that, if the original beneficiary die before the insured or for any other reason be eliminated so that only the face value of the policy is payable at the death of the insured, the amount of the premiums falling due after the elimination of this beneficiary will be reduced. In other words, the company charges an additional premium to cover the risk of the payment of 6 per cent per annum of the face value of the policy in monthly installments during the lifetime of the first beneficiary.

While the amount of the face of the policy will earn income, although materially less than 6 per cent, in the hands of the company during the period ensuing between the death of the insured and the death of the first beneficiary, this fact is doubtless taken into consideration by the company in fixing the amount of additional premium charged to cover the risk. The withholding of the payment of the face of the policy during the lifetime of the first beneficiary is one of the things contracted for by the insured and constitutes as much a part of the consideration for the liability to pay income during the life of the first beneficiary, assumed by the company as does the additional premium paid in cash. In view of these considerations it is impossible to escape the conclusion that the 6 per cent income payable to the first beneficiary during life under such a policy is not merely the payment of interest on the face value of the policy but is a part of the proceeds of the policy of insurance.

It is therefore held that where under a life insurance policy there is payable to a first beneficiary named 6 per cent per annum of the face value of the policy during life and, upon the death of the first beneficiary, the face value of the policy is payable to a second beneficiary, the payments to the first beneficiary are a part of the proceeds of the policy within the meaning of section 213(b) 1 of Revenue Act of 1918, and are not to be included in gross income for the purpose of the income tax.

SECTION 213(b), ARTICLE 72: Proceeds of insurance. 14–20–825 O. D. 433

Amounts received by an individual beneficiary or by the estate of the insured under the terms of an ordinary life, continuous installment bond contract issued by a life insurance company are exempt from tax under the provisions of section 213(b) 1, Revenue Act of 1918. This applies not only to the installment payments received but also to any dividends received under the terms of the bond.

SECTION 213(b), ARTICLE 72: Proceeds of insurance.

(See 24–20–997; sec. 213(a), art. 31.) Taxability of damages received for alienation of a wife's affections.

SECTION 213(b), ARTICLE 73: Gifts and bequests.

(See 4–20–700, sec. 213, art. 32.) Taxability of payments made to executor in addition to commissions as such.

SECTION 213(b), ARTICLE 73: Gifts and bequests. 24–20–999
(Also Section 214(a), 4, 5, 6, Article 141.) O. D. 543

A, in 1893, purchased land for a summer residence and deeded the entire tract to his wife. Shortly thereafter a part of the land was

sold to B for the erection of a hotel. B defaulted and A bought the property in at a foreclosure sale (presumably before March 1, 1913), placing the title again in his wife's name. The income from the property was included in the returns of A's wife for 1913 to 1917, inclusive. During 1917, the property was transferred to A, but the deed was never recorded. For 1918 the income from the property was reported by A. In 1919, the property was sold, A's wife giving the deed.

Inasmuch as the land was deeded to A's wife as a bona fide gift in 1893, and as A, who loaned the money to B and of right held the mortgage upon the property, allowed the deed to remain in his wife's name when he bought the property in at the foreclosure sale, and because of the further fact that all the income for the years 1913 to 1917, inclusive, was reported in the returns of A's wife, this act indicating A's acknowledgment of her right to it, it is the opinion of this office that she was the real owner of the property during that period.

If the transfer to A in 1917 was a bona fide transfer, the fact that it was not properly recorded would not prevent the legal title thereto from vesting in him, and if the title so vested, he was clearly the owner thereof from that time on until the sale in 1919 and was entitled to include in his own returns income derived therefrom or to claim any allowable deductions. Upon the sale thereof, A could not be permitted, of course, to compute his gain or loss upon the basis of the fair market value of the property as of March 1, 1913, but would have to compute such gain or loss upon the basis of the cost to him or the fair market value of the property as of the date it was transferred to him in 1917. However, there are circumstances in the case which indicate that the parties did not consider the deed of 1917 as a valid and binding transfer. For instance, when the property was sold in 1919, the deed of transfer was executed by A's wife and the mortgage to secure a portion of the purchase price was taken in her name, being later assigned to A. The fact that A's wife continued to be the record owner until the date of sale also furnishes further ground for this conclusion.

The Unit is, therefore, of the opinion that A's wife was at all times during the period in question the real owner of the property and any gain derived or loss sustained upon the sale thereof in 1919 should be included in her return for that year.

The gain or loss will be the difference between the selling price plus any amount of depreciation sustained on the property since February 28, 1913, and the fair market value of the property as of March 1, 1913, plus the cost of any permanent improvements made since then and not claimed as a deduction in any return of income. What was the fair market value of the property as of March 1, 1913, is a matter of fact to be established by any evidence in the hands of A and his wife. In view of the foregoing ruling, it is held that for the years 1913 to 1919, inclusive, the income and expenses in connection with the property should have been included in the returns rendered by A's wife, and amended returns should be filed by both parties for the years in which A included them in his returns.

SECTION 213(b), ARTICLE 74: Interest upon State obligations. 15–20–843 O. D. 447

Bonds were issued by a municipality of Wisconsin, in accordance with the general city charter law of that State, to cover deferred installments of assessments against real estate for the cost of certain public improvements. Each bond was a lien upon all the property benefited to the extent of unpaid assessments and interest thereon. The bonds contained recitals that they were chargeable only to the particular property described therein, and that they should in no event constitute a general city liability.

Notwithstanding the bonds were not a general liability of the city, they were issued by the city for public purposes and are obligations of a political subdivision of a State within the meaning of section 213(b) 4 of the Revenue Act of 1918, and the interest upon such bonds is accordingly exempt from tax.

SECTION 213(b), ARTICLE 74: Interest upon State obligations. 19–20–911 O. D. 491

A city acquires property for park purposes by condemnation proceedings and pays for it by special assessments upon the districts considered to be specially benefited by the proposed improvement. Assessments are payable in installments over a period of 10 years. In order to obtain funds with which immediately to compensate the owners of the property condemned, the city issues "park fund certificates" in the nature of 10-year bonds, payable out of the assessments collected. Certificates are sold to the public and entitle the holders thereof to their pro rata shares of the assessments and interest thereon. The assessments are collected annually by the city treasurer, who pays the amount collected, with interest, to the holders of the certificates.

Held, that the park fund certificates are obligations of the municipality, a political subdivision of the State, and that the interest paid thereon by the city in behalf of the legally authorized assessment districts under its control is not subject to the normal tax imposed by section 210 nor to the graduated surtaxes imposed by section 211 of the Revenue Act of 1918.

SECTION 213(b), ARTICLE 74: Interest upon State obligations. 24–20–1000 O. D. 544

In some of the Western States irrigation districts are created by an election duly called for the purpose. The county assessor of the county in which the land benefited is located assesses all such property on the assessment rolls of the county and a tax is levied and collected in the same manner as other taxes are levied and collected.

Held, the district is a political subdivision of the State and interest on its bonds is exempt from income tax.

SECTION 213(b), ARTICLE 77: Interest upon United States obligations. 3–20–684 O. D. 368

The principal of bonds issued by the people of Porto Rico is exempt from taxation by the United States under the Act of Congress approved March 2, 1917. The interest derived from such bonds is exempt from income, war profits, and excess profits taxes under the provisions of section 213(b) 4, Revenue Act of 1918.

SECTION 213(b), ARTICLE 77: Interest upon United States obligations. 13–20–807 O. D. 420

Bonds issued by the military government of Santo Domingo in behalf of and payable from the revenues of the Dominican Republic while that country was under temporary military occupation by the United States are not obligations of the United States or of a possession of the United States within the meaning of section 213(b) 4, of the Revenue Act of 1918, and the interest thereon is not exempt from normal and additional taxes imposed by that Act.

SECTION 213(b), ARTICLE 79: Liberty bond exemption from surtax and war profits and excess profits tax in 1918. 19–20–912 O. D. 492

It is deemed inadvisable to use Form 1125, which is directly applicable only to the year 1919, and subsequent years, in computing taxable interest from Liberty bonds for the year 1918.

There are exemptions covered by this form which were not applicable to interest received during 1918 and the form does not provide for computing taxable interest subject to rates for different years, which is necessary for 1918 in the case of interest derived through a partnership with a fiscal year different from the taxpayer's taxable year.

SECTION 213(b), ARTICLE 80: Liberty bond exemption after December 31, 1918. 8–20–752 O. D. 405

An individual who inherits fourth Liberty loan bonds or Victory loan notes which were originally subscribed for by the decedent is not entitled to the collateral exemption of interest on bonds of previous issues to which the decedent as the original subscriber would have been entitled.

SECTION 213(b), ARTICLE 80: Liberty bond exemption after December 31, 1918. 19–20–913 O. D. 493

The amount of interest upon Liberty bonds of any particular loan exempt from surtax and war profits and excess profits tax is in no case based on the amount of bonds of that loan subscribed for and

still held at the time of filing the returns. However, the conditional exemption of interest upon Liberty bonds of other loans by reason of original subscription and continued holding of Liberty bonds of the Fourth loan, or Victory notes, is based upon the amount of Liberty bonds of the Fourth loan and Victory notes originally subscribed for and still held by the taxpayer at the time of filing his return. (Ruling 1–19–40, O. D. 28; p. 89 Cumulative Bulletin, December, 1919, modified.)

SECTION 213(b), ARTICLE 80: Liberty bond exemption after December 31, 1918. 20–20–932 O. D. 502

If a partnership was an original subscriber to Liberty bonds of the fourth Liberty loan 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 of the Revenue Act of 1918, the corporation will be considered as the "original subscriber" to the bonds. An individual member of the partnership purchasing from the corporation bonds of the fourth Liberty loan originally subscribed for by the partnership and taken over by the corporation would not be considered the original subscriber thereof.

Treasury Decision 2857 provides that for the purpose of the conditional exemption of $20,000 Victory notes of either series issued upon conversion of Victory notes of the other series which were originally subscribed for by any taxpayer will be deemed to have been originally subscribed for by such taxpayer.

SECTION 213(b), ARTICLE 81: Liberty bond exemption in the case of trusts.

(See 16–20–861; sec. 213(c), art. 93.) United States Liberty bonds or Victory notes held in trust for nonresident alien life beneficiary.

SECTION 213(b), ARTICLE 82: Liberty bond exemption in the case of partnerships and personal service corporations. 2–20–672 O. D. 362

Where Liberty bonds are subscribed for and continuously held by a partnership and one of the partners purchases the bonds directly from the partnership, the purchaser is entitled to the exemption which is conditioned upon original subscription to and continuous holding of the bonds. The basis of the exemption will be an amount of the bonds not in excess of (1) his original share of the bonds held by the partnership, or (2) his share of such bonds not sold by the partnership plus the amount bought by him from the partnership; whichever amount is smaller. However, if the bonds are purchased from another partner or they are sold by the partnership and repurchased by him in the open market, he can not claim such exemption in respect to any amount of the bonds so acquired.

SECTION 213(b), ARTICLE 83: Income of foreign Governments. 15-20-844 O. D. 448

Interest credited by a domestic bank to the account of a foreign bank, part of whose stock is owned by a foreign Government, is not exempt from income tax under section 213(b) 5 of the Revenue Act of 1918.

SECTION 213(b), ARTICLE 83: Income of foreign Governments. 18-20-895 O. D. 483

Income from sources within the United States received by a foreign ruler in his individual capacity is subject to income tax. Income received by him from property belonging to the Crown is not.

SECTION 213(b), ARTICLE 83: Income of foreign Governments. 21-20-951 O. D. 515

Inasmuch as section 213(b) of the Revenue Act of 1918 expressly provides that the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such governments, or from any other source within the United States is exempt from taxation, it is held that a foreign government is not subject to tax on income derived from the operation of vessels owned by such government through its agents in the United States. Neither is the foreign government liable to tax upon the income arising from the operation for its benefit of vessels chartered by it.

SECTION 213(b) ARTICLE 84: Income of States. (Also Section 219, Article 341.) 18-20-896 S. 1374

INCOME TAX—REVENUE ACT OF 1916, AS AMENDED BY THE REVENUE ACT OF 1917.

Where executors under a will hold property specifically bequeathed to a governmental agency of a State, and other assets of the decedent's estate are sufficient to pay all debts, income received by the executors during the period of administration from such property is not taxable in the hands of the executors under section 2(b) of the Revenue Act of 1916.

Opinion is requested as to whether income from property specifically bequeathed to a State university constitutes taxable income in the hands of the executors under the decedent's will, when other assets of the estate are sufficient to pay all debts.

Section 2(b) of the Revenue Act of 1916, provides in part, 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. * * *

The university is an institution created under State laws and is controlled by officers appointed in accordance with provisions of the State constitution. It is supported by State funds and all the property used is vested in the State. The officers of the university are authorized to accept gifts to it, the title to which vests in the State. Bonds may be authorized, pledging State property for their payment, to erect, furnish, and equip buildings for the use and benefit of the university, under the supervision of a building commission appointed by the governor of the State. In short, the institution is State owned, controlled, and operated in every sense.

The education of the citizens of a State when conducted by the State or by its subdivisions or agencies is considered to be one of the public governmental functions of that State.

Certain property was bequeathed to this institution by will and the income therefrom was turned over to the institution by the executors.

It is an elementary principle that the Federal Government has no authority, under our system of government, to impose a tax upon a State or any subdivision thereof. (Cooley on Taxation, Vol. I, p. 153; *Ward* v. *Maryland*, 12 Wall. 418; *Collector* v. *Day*, 11 Wall. 113; Law Opinion 895.) Nor may it levy such a tax indirectly. (*United States* v. *B. & O. R. R. Co.*, 17 Wall. 322.) The facts in the latter case are comparable to those here presented. There, the city of Baltimore held bonds of the Baltimore & Ohio Railroad Company to a large amount and the internal revenue law of the United States then in force required every railroad corporation indebted upon bonds, or upon coupons representing bond interest, to pay a tax of 5 per cent upon all such interest or coupons and authorized the company to retain the amount so paid as a tax from the creditor. The railroad company in this case refused to make the payment so far as it concerned the interest on bonds held by the city of Baltimore, and the court sustained the refusal, holding that the tax was not in effect a tax upon the railroad company, but upon its creditors and, in the case in question, the tax was not more competent than if imposed directly upon the city; and the Attorney General has held that a Federal Revenue Act imposing a tax upon the gross receipts of all transportation companies is not applicable to a railroad company owned by a State. (12 Op. Atty. Gen. 277. See also 12 Op. Atty. Gen. 402.) It necessarily follows from these decisons that Congress is without power to levy a tax upon income accruing on property held in possession by executors under a will when there are no creditors and the property is legally certain to be delivered at the expiration of the legal period of administration to a State or an agency thereof, since whatever amount levied and paid would reduce by so much the amount paid over to the agency of the State at the termination of the period of administration.

The conclusion reached is strengthened by the fact that under the laws of the State the title to property specifically devised or be-

queathed passed by will. The title to the stocks bequeathed in this case, then, vested immediately upon the death of the testator in the State university, although under the State laws such property is held in possession of the executor until the termination of the period of administration. Under such circumstances, a tax directed against income from such property, although held in possession of the executors under the will, would be a tax upon income from property, the title to which has vested in a State university, a governmental agency of that State, and would in my opinion be illegal.

It is, therefore, held that where executors under a will hold property specifically bequeathed to a governmental agency of a State, and other assets of the decedent's estate are sufficient to pay all debts. income received by the executors during the period of administration from such property, is not taxable in the hands of the executors under section 2(b) of the Act of 1916.

SECTION 213(b), ARTICLE 85: Compensation of State officers. 3-20-685 O. D. 369

The compensation paid trustees of a corporation, who have filed an application for winding up the affairs of said corporation in accordance with the laws of the State of Connecticut, is not exempt from income tax, as the trustees are not receivers in fact and do not appear to exercise a public function under an appointment of the court, nor are they invested with the character of an officer or employee of the State, although the compensation is fixed by the court.

SECTION 213(b), ARTICLE 85: Compension of State officers.

(See 4-20-702; sec. 214(a) 1, art. 101.) Salary paid by a city to a member of a partnership and by him turned over to the partnership in accordance with his contract.

SECTION 213(b), ARTICLE 85: Compensation of State officers. 14-20-826 O. D. 434

Pensions received from a State or a political subdivision thereof by its retired employees are exempt from tax.

Persons serving on the jury of a State, county, or municipal court are held to be employees of a State or a political subdivision thereof, and fees and compensation received by them are accordingly exempt from tax.

SECTION 213(b), ARTICLE 85: Compensation of State officers. 15-20-845 O. D. 449

Compensation received by individuals holding the positions of "State agent of normal schools for whites," "State agent of normal schools for negroes," and "high school inspector," which positions were created by the superintendent of public instruction of a State

without statutory authority, is not exempt from tax as compensation received from a State or a political subdivision thereof, when such compensation is paid from an endowment fund no part of which is under State control.

SECTION 213(b), ARTICLE 85: Compensation of State officers. 18–20–897 O. D. 484

Where clerks of State courts employ clerical assistants in connection with the administration of the Federal naturalization laws and pay the salaries of such assistants out of fees collected by them, which fees are made available for that purpose by congressional appropriation, the compensation received by the assistants is income subject to tax under the provisions of the Federal income tax laws. Clerical assistants so employed are not State employees by virtue of such employment.

SECTION 213(b), ARTICLE 85: Compensation of State officers. 19–20–914 O. D. 494

The New York transfer (inheritance) tax law provides for the appointment of an attorney in each county to look after the State's interests in the collection of inheritance taxes. In 1914 A was appointed by the State comptroller as attorney in a certain county and has since then continued in that position. He receives as compensation a commission upon the transfer of most of the estates; in other cases he is paid such fees and allowances as the comptroller decides are reasonable and proper. It is stated that in the service of all papers upon him relating to transfer tax proceedings, service is recognized as being upon the comptroller and further that all of his official acts are representative of the comptroller, being so recognized by the courts.

Held, that the compensation received by A in the capacity of attorney for the State comptroller is not subject to Federal income tax under the provisions of article 85 of Regulations 45.

SECTION 213(b), ARTICLE 85: Compensation of State officers. 20–20–933 O. D. 503

A receiver was appointed by a State court for the assets of a corporation, a part of which were located in the State appointing the receiver and the remainder in another State. The Federal district court for the latter State appointed the same person as receiver for the assets located in that State. The fees arising from the receivership are allowed in a lump sum, such compensation being fixed by the State court and approved by the Federal court.

Held, that the exemption from taxation as compensation of a State employee applies only to that portion of the fee which is attributable to the appointment by the State court; the portion attributable to the appointment by the Federal court should be reported as taxable income by the recipient. The court fixing the compensation should be requested to allocate the portions reasonably attributable to the State and Federal appointments.

SECTION 213(b), ARTICLE 85: Compensation of State officers. 22-20-968 O. D. 525

A referee in drainage is appointed by the district judge of the State judicial district in which the drainage project is located. The judge is vested with authority to provide for the payment of the referee's salary, to regulate his duties, and to discharge him at pleasure.

Held, that the referee is an employee of a political subdivision of the State and that his salary as such is not subject to tax under the Revenue Act of 1918.

SECTION 213(b), ARTICLE 85: Compensation of State officers. 24-20-1001 O. D. 545

A partnership of civil engineers is employed under contract by an irrigation district of a State to serve in the capacity of consulting and supervisory engineers in connection with the development of that district. The agreement provides that the partnership is to receive for its services a stipulated sum per annum in addition to expenses and that for all time in excess of 60 days in any one year it is to be paid at the rate of x dollars per day in addition to expenses. The agreement further provides that all engineering work in connection with the district is to be performed under the general direction of the partnership.

Whether the compensation in question is exempt from tax depends upon whether the partnership is an employee of the irrigation district. The term employee is ordinarily understood to mean one who is in the regular and continual service of his employer and who is subject to the direction and control of the employer, the relation between the employer and employee (as in the relation between master and servant), implying that the employer not only prescribes to the employee the end of his work, but directs or at any moment may direct the means also, or retain the power of controlling the work.

This firm not only has a contract with the irrigation district for its services, but also has similar contracts with the other districts and counties, and at the same time accepts business from the public in general, so that it can not be said to be in the regular and continuous employ of the irrigation district. Neither does it appear that the work performed by the partnership is subject to the direction and control of the directors in the sense that the work of an employee is directed and controlled by his employer. The relation existing between the partnership and the directors is similar to the relation existing between a firm of attorneys and a client who pays the attorneys an annual retainer for any legal services the client may require. The yearly compensation stipulated in the contract between the directors and the partnership is in the nature of a retainer paid to the partnership in order that the professional services of its members may be available to the directors in connection with any engineering question that may arise in connection with the irrigation district. Under the terms of the agreement a minimum sum is payable to the firm even though it may not be called upon to perform any actual service during the year.

It is concluded, therefore, that the relation of employer and employee does not exist between the irrigation district and the partnership and consequently the compensation received by the firm from the district is not exempt from tax as compensation paid its employees by a political subdivision of a State.

SECTION 213(b), ARTICLE 85: Compensation of State officers. 25-20-1013 O. D. 553

In constructing a causeway, the salaries received by the individuals employed thereon are paid from the funds of three railway companies and a county, which is part owner of the project. The county pays its pro rata share of the salaries to one of the railway companies, which by its check pays the gross amount of the salaries.

Held, that as the employees constructing the causeway are not employed by and are not under the direction or control of the State or any political subdivision thereof, they do not come within the designations "State officers" or "Employees of a State" as used in article 85, of Regulations 45, and, therefore, their compensation is not exempt from income tax.

SECTION 213(b), ARTICLE 86: Compensation of soldiers and sailors. 3-20-686 O. D. 370

The following items are to be included in the $3,500 exemption provided in section 213(b) 8, Revenue Act of 1918, for salary or compensation received by persons in the military or naval forces of the United States during the "present war":

Bonus payable upon discharge.

Mileage from point of discharge to point of enlistment.

Ration money covering periods of absence from camp on furlough.

SECTION 213(b), ARTICLE 86: Compensation of soldiers and sailors. 14-20-827 O. D. 435

Army field clerks are persons in the military forces of the United States within the meaning of section 213(b) 8 of the Revenue Act of 1918.

The right to the $3,500 exemption in the case of "reconstruction aides" in the Army is dependent upon their status, whether military or civil, while engaged in such work. The exemption would not be allowed in the case of a civilian so engaged, whereas it would be allowed in the case of a member of the military forces under similar assignment without change of status.

SECTION 213(b), ARTICLE 86: Compensation of soldiers and sailors. 14-20-828 O. D. 436

An officer of the National Guard detailed to the General Staff College is not considered to be in active service in the military forces of the United States and therefore is not entitled to the $3,500 exemption provided in section 213(b) 8 of the Revenue Act of 1918.

SECTION 213(b), ARTICLE 86: Compensation of soldiers and sailors. 16–20–859 O. D. 462

Persons in the Army Transport Service, although amenable to military law, are, for income tax purposes, regarded as civilian employees attached to the military forces rather than as persons in the active military forces of the United States. Accordingly, they are not entitled to the $3,500 exemption provided by section 213(b) 8 of the Revenue Act of 1918.

SECTION 213(b), ARTICLE 86: Compensation of soldiers and sailors. 16–20–860 O. D. 463

The retainer pay received by Naval Reservists while on inactive duty may not be included in the $3,500 exemption of compensation received for active service in the military or naval forces of the United States, but should be returned for income tax purposes.

SECTION 213(b), ARTICLE 86: Compensation of soldiers and sailors. 18–20–898 O. D. 485

Employees of the Knights of Columbus War Activities are not considered to be in active service in the military or naval forces of the United States, and therefore are not entitled to the exemption provided by section 213(b) 8 of the Revenue Act of 1918.

SECTION 213(b), ARTICLE 86: Compensation of soldiers and sailors. 19–20–915 O. D. 495

The executive order dated April 3, 1917, relative to the United States Public Health Service contains the following explicit declaration:

> Under the authority of the Act of Congress, approved July 1, 1902, and subject to the limitations therein expressed, it is ordered that hereafter in times of threatened or actual war the Public Health Service shall constitute a part of the military forces of the United States, and in times of threatened or actual war, the Secretary of the Treasury may, upon request of the Secretary of War or the Secretary of the Navy, detail officers or employees of said service for duty either with the Army or the Navy.

Inasmuch as the present is within the language of the executive order a time of "actual war" it is clear that the personnel of the Public Health Service "constitute a part of the military forces of the United States."

The definition found in the Act expressly declares that it "shall not be deemed to exclude other units" otherwise included within the term "military forces of the United States."

The personnel of the Public Health Service are therefore "persons in the military * * * forces of the United States" within the meaning of section 213(b) 8 of the Revenue Act of 1918.

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

SECTION 213(c), ARTICLE 91: Gross income of nonresident alien individuals.

(See 21–20–955; sec. 221, art. 361.) Withholding in case of interest on bonds of domestic corporation operating in a foreign country where control is exercised by receivers appointed by a United States court.

SECTION 213(c), ARTICLE 91: Gross income of nonresident alien individuals. 23–20–985 O. D. 534
(Also Section 233, Article 550.)

Where foreign corporations or nonresident alien individuals purchase British Government treasury bills at a discount in United States markets and *collect the same at maturity* either in the foreign country or from the paying agent of that Government in the United States, such discount is not income from sources within the United States and is not subject to tax.

Where foreign corporations or nonresident alien individuals purchase British Government treasury bills at a discount in United States markets and *sell the same at a profit* in the United States, such profit is income from sources within the United States and as such is subject to tax.

SECTION 213(c), ARTICLE 92(a): When wages of a nonresident alien seaman are derived from sources within the United States. 26–20–1027 O. D. 559

A steamer engaged in foreign trade which lies for a period of two weeks in a United States port for the purpose of completing repairs is deemed to be in such port a reasonable time for the transaction of business and accordingly wages paid to its nonresident seamen during such period are held to be income from sources without the United States and hence are not subject to the withholding provisions of the Revenue Act of 1918.

SECTION 213(c), ARTICLE 93: Income of nonresident aliens from United States bonds. 16–20–861 O. D. 464
(Also Section 213(b), Article 81.)

When trustees hold United States Liberty bonds or Victory notes in trust for a nonresident alien life beneficiary and are to distribute the income periodically, the bonds and notes are held to be "beneficially owned" by such nonresident alien within the meaning of section 4, Victory Liberty Loan Act of March 3, 1919, and articles 81 and 93 of Regulations 45.

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

SECTION 214(a) 1, ARTICLE 101: Business expenses.

(See 2–20–669; sec. 212, art. 23.) Deduction by a vendee of Federal taxes paid according to contract on profits accruing to a vendor from sales made to the vendee.

SECTION 214(a) 1, ARTICLE 101: Business expenses. 2–20–673 O. D. 363

A member of a local draft board who used his automobile for travel on business in connection with the work of the board did so for his personal convenience and not by reason of official necessity, since such members, when traveling under competent orders, were allowed actual traveling expenses plus a per diem of four dollars. Accordingly any amount representing wear and tear of the automobile or maintenance expense would not be an allowable deduction from gross income.

SECTION 214(a) 1, ARTICLE 101: Business expenses. 4–20–702 A. R. M. 25

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

An individual member of a partnership received a salary for services performed as an employee of a city and, in accordance with his contract with the firm, turned over to it, as the value of his time, the entire amount so received.

Held, that the individual partner might deduct the amount of the salary in his personal return as a business expense, but that no deduction could be claimed by the partnership, since to allow the amount received by it to be treated as exempt income would in effect be to regard it as an employee of the city, which was not the fact.

SECTION 214(a) 1, ARTICLE 101: Business expenses.

(See 5–20–721; sec. 1, art. 1510.) Advertising and sales promotion expenditures in connection with Government contracts.

SECTION 214(a) 1, ARTICLE 101: Business expenses. 6–20–726 O. D. 396

A taxpayer who borrowed money for business purposes and was required to take out life insurance in favor of the lender as security for the loan, is entitled to deduct the premiums paid for such insurance as a business expense under Section 214(a) 1 of the Revenue Act of 1918; however, the premiums will cease to constitute a business expense upon maturity and payment of the loan.

SECTION 214(a) 1, ARTICLE 101: Business expenses.

(See 8–20–753; sec. 214(a) 2, art. 121.) Payment under guaranty of interest of an insolvent principal.

SECTION 214(a) 1, ARTICLE 101: Business expenses. 13–20–808 O. D. 421

Membership fees or dues paid by individuals and corporations to a chamber of commerce or board of trade are deductible from gross income as a business expense provided the membership is employed as a means of advancing the business interests of the individual or corporation.

SECTION 214(a) 1, ARTICLE 101: Business expenses. 15–20–846 O. D. 450

Dues paid by an individual to an organized labor union are deductible as a business expense in computing his net income for income tax purposes.

SECTION 214(a) 1, ARTICLE 101: Business expenses.

(See 17–20–885; sec. 215, art. 293.) Seat on exchange purchased by partnership.

SECTION 214(a) 1, ARTICLE 101: Business expenses. 19–20–916 O. D. 496

A certain lumber exporters' association was organized for the purpose of promoting in all lawful ways the general business interests of exporters of forest products by the collection and dissemination to its members of information and statistics relating to such export business. This purpose is accomplished by protecting the lumber export business against unjust discriminations and restrictions by whomsoever imposed; by the establishment of uniform practices, customs, and usages in the trade and by the establishment, if deemed necessary, of an inspection and classification service for the use and protection of its members.

Held, that membership dues paid by the members of this association represent a consideration for benefits flowing directly to them as an incident of their business and may, therefore, be deducted from gross income.

SECTION 214(a) 1, ARTICLE 101: Business expenses. 20–20–934 A. R. R. 98

(Also Section 214(a) 8, Article 167.)
(Also Section 234, Article 561.)

Held in the matter of the appeal of the M Company, that it is entitled to deduct as ordinary and necessary operating expenses certain amounts expended in litigation defending its right, title,

and interest in a certain patent after the patent had been issued by the Government, and that the total cost of such patent is represented by the various Government fees, cost of drawings, experimental models, attorneys' fees, etc., actually paid before such patent was issued.

The Committee on Appeals and Review has had under consideration the appeal of the M Company from a decision of the Income Tax Unit disallowing for 1917 an item of $3x$ dollars of which the company concedes that $2x$ dollars was properly disallowed as representing items which entered into the cost of the patent and which should have been capitalized, but urges that certain items of expense amounting to x dollars actually paid in defending its right, title, and interest in such patent, after the patent had been issued, constitute a necessary business expense.

The Income Tax Unit notified the corporation in 1919 that donations made by it did not constitute proper deductions from gross income; that patent expense is a capital expenditure and should be capitalized and the amount thereof returned to the corporation through depreciation charges prorated over the life of the patent, and that an additional tax was due for 1917. It is from this decision that the company appeals and contends that the decision of the Unit is (1) not based on a correct interpretation of the facts, and (2) that such decision is not upheld by the law or regulations.

In a letter addressed to the Income Tax Unit, the company admits that the item of $2x$ dollars was properly disallowed and acknowledges its liability for additional taxes for the year 1917. The company contends, however, that any items expended for attorneys' fees in defending its right, title, and interest in this patent, or in representing the company in infringement litigation, should be allowed as an ordinary and necessary business expense for the reason that such items added no value to the patent owned but were expenditures made solely to protect the rights of the company from infringement by other manufacturers who are infringing on the rights of this corporation.

The record shows that sometime prior to November, 1915, B, a stockholder, director, and officer of the M Company, invented a certain device and that he prepared drawings and working models and caused to be made payments covering Government filing fees, attorneys' fees, traveling expenses to and from Washington, all of which was made in the interest of this corporation and leading up to his securing a patent on his invention, which was later transferred to the corporation for a nominal sum. The amounts expended by the corporation in securing this patent and deducted in its return for 1917, totaled $2x$ dollars and x dollars was expended by the corporation in 1917 after it had acquired the patent for the objects and purposes stated above.

The corporation strongly urges that the last stated item should be allowed as a necessary operating expense of the corporation for the reason that this amount in no way added to the life or value of said patent.

Inasmuch as the corporation concedes the proper disallowance of $2x$ dollars of the total expenditure of $3x$ dollars, there is left the item of x dollars in dispute.

Article 174 of Regulations 33, revised, provides that:

An *allowable deduction* for any given year for return of *capital* invested in patents at time of issue will be an amount equal to one-seventeenth of the actual *cost*, in cash or its equivalent, of such patents. Where the patent has been secured from the Government, its *cost* will be represented by the various Government fees, cost of drawings, experimental models, attorneys' fees, etc., actually paid. Where the patent has been purchased for a cash consideration, the amount paid therefor would represent the capital invested therein. If the corporation purchased a patent and made payment therefor in stock or other securities, the actual cash value of such stocks or other securities at the time of the purchase will represent the cost of capital invested in the patent. If the patent was purchased after a part of its life had expired, the cost for the purpose of a deduction for return of capital will be ratably spread over the remaining years of its life. * * *

The above-quoted provisions of Regulations 33, revised, have been carried forward and made a part of article 167 of Regulations 45. Paragraph 19 of Tax Reviewers Minutes provides that:

Where the cost of a patent (whether acquired for cash or otherwise) has been written off the books, either in accordance with the principles laid down in article 174 of Regulations 33, revised, governing the collection of the income tax, or because the patent has expired, no part of such cost may be restored to the capital account—either as good will or otherwise—for purposes of computing invested capital.

Article 841 of Regulations 45 provides that:

Addition to surplus which a corporation may desire to make under the preceding article falls broadly into two classes:

(1) To correct returns of net income for prior years in which actual errors have been made; as, for example, where excessive depreciation has been deducted, additions to plant and equipment or other capital charges have been charged off as an expense, inventories have been taken upon a wrong basis of valuation, etc.

(2) To reinstate in surplus deductions from income which are as a matter of good accounting to some extent optional, such as experimental expenses, patent litigation, development of good will through advertising or otherwise, etc.

Adjustments falling in class (1) will be permitted for all years whether before or after March 1, 1913, provided amended returns of net income are filed for each year in which an erroneous return has been made. Due consideration will be given to the assessment of penalties in any case in which a fraudulent return has been made. Adjustments falling in class (2) can not be permitted, as in such cases it is considered that the corporation has exercised a binding option in deducting such expenses from income. An election of this sort which was made concurrently with the transaction can not now be revised, and amended returns in respect thereof can not be accepted. * * *

The Committee is of the opinion that the amounts expended by this corporation after it secured the patent are not a part of the cost of the property for the reason that such amounts do not add to or prolong the life of the property in question and can not be considered as an improvement or betterment. The amount so expended having none of the elements of improvement or betterment can not be returned to the corporation through depreciation charges in accordance with the provisions of article 174, Regulations 33, revised, quoted above. Only such amounts as represent the actual cost of this patent can be deducted by way of depreciation annually by this corporation. The title and ownership of the patent was in the corporation and the amounts expended were not made in perfecting its title to the patent already owned and used by the company.

The conclusion of the Committee is that the amounts expended by the corporation in the instant case in litigation, after the patent had

been secured by B and had been transferred to the corporation, constitute necessary operating expenses and should not be capitalized.

In view of the foregoing the Committee recommends that the item of x dollars should be allowed as a necessary operating expense; that the amount of $2x$ dollars should be charged to capital account and returned by way of depreciation to the corporation over the life of the patents and that to this extent the decision of the Income Tax Unit be reversed.

SECTION 214(a) 1, ARTICLE 101: Business expenses.

(See 23–20–988; sec. 219, art. 343.) Deductibility of expenses of administration in computing income of estate.

SECTION 214(a) 1. ARTICLE 101: Business expenses. 25–20–1014
O. D. 554

A bequeathed to his widow, for the term of her natural life, various orange groves in Florida and during the freeze of two years ago trees to the number of 2,125 were seriously injured. Grafting, special fertilizing, etc., were resorted to, to restore them. Some of the trees died, others are responding and will in time bear fruit. The widow expended x dollars from her personal income in such special expenses, and the question is whether she was entitled to deduct this amount from her personal income.

This is a situation which differs from that of life tenancy of a building or real estate the rentals of which the life tenant is entitled to. The widow evidently was under the necessity of actively conducting the operation of the orchard in order to receive any income therefrom. There can be no question that such expenditures as are occasioned by the growing and marketing of a crop would be allowable deductions, and the deduction sought is of this general character. Certainly the pruning and trimming of the orchard trees annually would be an allowable deduction, and grafting to replace deadened portions seems to be of the same general nature. The same is true of the application of fertilizer annually for the purpose of stimulating a crop. Such fertilizer normally stimulates both the growth of the trees and the fruit at the same time.

It is accordingly held that the amounts expended under the circumstances are properly allowable as a deduction for ordinary and necessary expenses of business, but the widow may not deduct any amount on account of loss of trees *totally destroyed* since, while the loss tends to reduce the income from the estate, it is not a loss to the life tenant but is a decrease in the corpus of the estate.

SECTION 214(a) 1, ARTICLE 104: Professional expenses.

(See 15–20–849; sec. 215, art. 293.) Expenditures incident to admission to practice law.

SECTION 214(a) 1, ARTICLE 105: Compensation for personal services. 9–20–767 A. R. M. 30

All the stock of a corporation was owned by its four officers, who devoted all their time and attention to the business of the corporation, acting not only as officers but also as buyers, bookkeepers, etc. These officers drew only nominal salaries of $1/36x$ dollars each for a number of years after organization.

The gross sales increased from $11x$ dollars in the first year of business to $64x$ dollars in 1916 and $90x$ dollars in 1917. Early in 1917, before the passage of any excess profits tax law, the board of directors fixed salaries of $2x$ dollars each for three of its officers and x dollars for the fourth. These salaries were paid in 1917 and deducted from gross income.

Held, that the amounts paid and deducted were reasonable and properly deductible from gross income.

SECTION 214(a) 1, ARTICLE 105: Compensation for personal services. 9–20–768 A. R. R. 31

A company's gross sales in 1917 amounted to $1000x$ dollars and its net income was $125x$ dollars. Salaries and contingent compensation were paid to its officers and certain employees as follows:

	Basic salary.	Total.
President and treasurer	$9x$ dollars.	$9x$ dollars.
Secretary and general manager	$6x$ dollars.	$18x$ dollars.
Assistant treasurer	$3x$ dollars.	$11x$ dollars.
Office manager	x dollars.	$9x$ dollars.
Office manager (Y office)	$2x$ dollars.	$10x$ dollars.
		$57x$ dollars.

Contracts were made prior to 1917 with these officers and employees for services to be performed. The value of the services to be performed and the possibility of securing more remunerative employment were taken into consideration in making the contracts. No payments were based on stock holdings. The contingent compensation or commission was paid for the purpose of retaining the services of men who had grown up with the business and were familiar with the various phases of the business, and was based on net profits after regular dividends had been paid.

The Committee recommends that the full amount of compensation paid be allowed as a deduction, since it represented the price paid for services pursuant to a free bargain made in advance between the individual and the business enterprise.

SECTION 214(a) 1, ARTICLE 105: Compensation for personal services. 9–20–769 A. R. R. 32

A started a business a number of years ago with a small amount of capital. At a later date, the business was incorporated, 90 per cent of the stock being issued to A. The business was developed by his efforts until in 1917 the gross sales amounted to $555x$ dollars

and the net income to $65x$ dollars, whereas in 1911 the gross sales amounted to only $167x$ dollars and the net income to $8x$ dollars. In prior years A, as president of the corporation, drew a nominal salary of x dollars, taking his earnings as dividends, but in 1917 his salary was increased to $10x$ dollars.

In view of the extraordinary circumstances of the case, including the fact that A is and has been the sole administrative officer of the corporation and devotes his entire time to its direction in all details, the salary of $10x$ dollars does not appear to be excessive and is, therefore, an allowable deduction as a business expense.

SECTION 214(a) 1, ARTICLE 105: Compensation for personal services. 14-20-829 A. R. M. 39

A, the president and treasurer of a close corporation, and B, its vice president, each held 45 per cent of the outstanding capital stock. C, its secretary, held 3⅔ per cent of the stock. Nominal salaries were paid to A and C. There was an agreement between A and B that A was to receive in addition to his share on his capital invested, direct compensation in proportion to the results he might achieve for the company. Accordingly A, and C also, received in 1915, 1916 and 1917 as additional compensation 10 per cent and 1 per cent, respectively, of the profits. These amounts, although large, were not in proportion to stock holdings and having been paid according to agreement made in advance and for services rendered are held to be deductible as ordinary and necessary business expenses of the company.

SECTION 214(a) 1, ARTICLE 105: Compensation for personal services. 14-20-830 A. R. R. 53

The Committee has reached the conclusion that where salaries have been fixed long before any excess profits tax law was contemplated the Income Tax Unit is not authorized by the law or regulations to arbitrarily fix the salaries of the officers of any company at an amount less than that authorized. In general, the Committee does not think that the Unit is authorized by law or regulation to look back of any corporate action fixing the salaries of officers when such action was taken by the directors long before any excess profits tax law was even contemplated, and where the salaries were not fixed on the basis of stock ownership or do not bear a close relationship thereto. Neither, in the judgment of the Committee, is the Unit authorized to look back of any corporate resolution fixing salaries after the passage of the excess profits tax law, provided there is no evidence of intent to reduce the tax of the corporation, and provided that after deducting the amount actually fixed and paid the corporation has a normal return on its invested capital left, or where such deduction does not reduce the net earnings subject to tax below that of competing concerns which secure the services of officers and employees by open bargaining.

SECTION 214(a) 1, ARTICLE 105: Compensation for personal services. 15–20–847 A. R. R. 61

In cases where compensation is determined after the services have been rendered, reasonableness of such compensation is ordinarily the test of deductibility.

SECTION 214(a) 1, ARTICLE 105: Compensation for personal services. 20–20–935 O. D. 504
(Also Section 234, Article 561.)

The compensation of the officers of a corporation had been continued without change for several years. In 1919, two days before the close of its fiscal year, the salaries of the principal officers of the corporation were largely increased for the year then closing.

Section 234(a) of the Act of 1918 provides that in computing the net income of a corporation subject to tax there shall be allowed as deductions all ordinary and necessary expenses paid or incurred during the taxable year, including a reasonable allowance for salaries. The authorization to increase the salaries in question occurred before the books were closed for the fiscal year, and as such became a liability of the corporation for that year. If the compensation thus authorized was reasonable the total amount is an allowable deduction.

SECTION 214(a) 1, ARTICLE 107: Bonuses to employees. 19–20–917 O. D. 497
(Also Section 213(a), Article 52.)

The M Company, years ago, established an annual bonus system for paying its officers and employees additional compensation for services rendered. In 1914, 1915, and 1916 no bonuses were paid, and on January 1, 1917, the system was abolished. The bonuses as to amount were always fixed by an officer who resided in Europe, and who usually visited this country once a year. War conditions in 1917 and 1918 prevented his visiting this country, and consequently the amount of the bonuses was not determined until his visit in 1919, at which time bonuses were paid for 1916.

Held, that the bonuses in question were not paid on account of services rendered during the year 1919, and therefore can not be deducted as items of business expense for that year. Bonuses or additions to salaries voted subsequent to the close of any taxable year, and also subsequent to the closing of the books for such taxable year can not be considered as ordinary and necessary expenses of doing business during such year as are deductible under the Revenue Act of 1918.

The aggregate of these bonuses constitutes income to the recipients for the year 1919 because they were first credited to them and made available during that year.

SECTION 214(a) 1, ARTICLE 109: Rentals.

(See 3–20–689; sec. 214(a) 3, art. 133.) Assessments for local benefits paid by tenant for landlord.

SECTION 214(a) 1, ARTICLE 109: Rentals. 6-20-727
O. D. 397

A business property was leased for a term of years, but prior to the termination of the lease the lessor paid a fixed sum to the lessee for its cancellation.

Held, that the amount so paid by the lessor constitutes a business expense and that he may deduct an aliquot part thereof in his return for the year in which the lease was canceled and for each succeeding year the lease had to run.

SECTION 214(a) 1, ARTICLE 109: Rentals. 21-20-952
O. D. 516

A corporation leased a building for a period of 10 years, and as lessee agreed to make any desired improvements or alterations at its own expense. Upon termination of the lease the premises will revert to the lessor together with all improvements and alterations so made or at the option of the lessor the lessee may be required to remove same at its own expense and restore the premises to their original condition.

Held, that the lessee may pro rate the cost of the alterations and improvements over the life of the lease and claim a suitable deduction each year, but that it may not set up a reserve to cover the cost of restoring the premises to their original condition. The expense of restoring the property at the expiration of the lease, if the lessee is required to restore it, will be an allowable deduction for the year in which it is actually incurred.

SECTION 214(a) 1, ARTICLE 111: When charges deductible. 3-20-687
O. D. 371
(Also Section 214(a) 3, Article 131.)

The New York State franchise tax imposed for the privilege of doing business in that State for the fiscal year of the State ending October 31, 1920, is based on 1918 income, but is not due and payable until a later date. A taxpayer making a calendar year return on an accrual basis may deduct two-twelfths of such tax in his return for 1919 and ten-twelfths in his return for 1920.

SECTION 214(a) 1, ARTICLE 111: When charges deductible.

(See 5-20-713; sec. 214(a) 3, art. 131.) Deduction of munitions tax by taxpayer keeping books on accrual basis.

SECTION 214(a) 1, ARTICLE 111: When charges deductible. 6-20-728
O. D. 398

Where a corporation engaged in buying and selling real estate purchases a piece of property and holds it for a profit, the interest, taxes, and ordinary repairs incident to the property represent

charges for the year in which paid or are so charged upon the books as to represent liabilities of the corporation and are allowable deductions in computing net income even though in excess of the gross income derived from the property. Such charges are not capital expenditures if the corporation has any income from which to deduct them and they should not be added to the cost of the property in determining the amount of gain or loss arising from its sale except to the extent that the corporation has no gross income from any source against which to deduct such expenditures for the taxable year in which they were made.

SECTION 214(a) 1, ARTICLE 111: When charges deductible.

(See 8–20–754; sec. 214(a) 3, art. 131.) Deductibility of Federal income tax in return of corporation for fiscal year ending in 1917 prior to October 3.

SECTION 214(a) 1, ARTICLE 111: When charges deductible.

(See 26–20–1028; sec. 214(a) 12, art. 261.) When loss sustained through return of goods in 1919 which had been sold in 1918 is deductible.

SECTION 214(a) 2.—DEDUCTIONS ALLOWED: INTEREST.

SECTION 214(a) 2, ARTICLE 121: Interest.

(See 7–20–745; sec. 250, art. 1003.) Interest paid or accrued under section 250.

SECTION 214(a) 2, ARTICLE 121: Interest. 8–20–753
(Also Section 214(a) 1, Article 101.) S. 1298
(Also Section 214(a) 7, Article 151.)

INCOME TAX—SECTION 234(a) 5, REVENUE ACT OF 1918.

Payment under guaranty of interest of an insolvent principal is a legal deduction from the gross income of the corporation making the payment, either as an operating expense or as interest, or as a bad debt, provided it is charged off the books of account of the guarantor.

The question is presented as to the deductibility from gross income for the year 1918 of an amount of interest paid by the M Company, under a guaranty, upon bonds of an insolvent principal.

The Revenue Act of 1918 provides for the deduction from gross income in returns of corporations of "ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business" (sec. 234(a) 1); also of "all interest paid or accrued within the taxable year on its indebtedness" (sec. 234(a) 2);

and of "losses sustained during the taxable year and not compensated for by insurance or otherwise" (sec. 234(a) 4).

The facts in the instant case are that the M Company has guaranteed both the principal and interest of outstanding bonds of the N Company. At the time the guaranty was made the M Company controlled the N Company through ownership of its capital stock. Subsequently the M Company was forced to sell this stock.

During the calendar year 1918 the M Company paid for the account of the N Company interest coupons aggregating x dollars, which amount the M Company "proposes to charge to profit and loss in its accounts for the calendar year 1918."

From the facts stated it is obvious that the payment made by the M Company in 1918 was not a voluntary expenditure, but was made in the discharge of an obligation. Since it has guaranteed the payment of the interest upon the bonds of the N Company, the payment by the M Company of such interest was a payment by it upon its indebtedness and the amount of the payment is deductible from gross income in the return of the M Company, provided the amount were shown as a payment of interest by such company. It appears, however, that the company prefers to charge it as a loss to the profit and loss account. There does not appear to be any reason why the company should not so treat the item and deduct it from gross income as a loss sustained during the taxable year.

It is therefore held, that payment under guaranty of interest of an insolvent principal is a legal deduction from the gross income of the corporation making the payment, either as an operating expense or as interest, or as a bad debt, provided it is charged off the books of account of the guarantor.

SECTION 214(a) 2, ARTICLE 121: Interest. 21–20–953
(Also Section 219, Article 343.) A. R. R. 113

Recommended that the action of the Unit in holding that interest accrued on notes of a decedent, paid by the administrator of his estate after his death, is not an allowable deduction from income in the return of the administrator, be modified.

The Committee has had under consideration the appeal of A, administrator of the estate of B, from a decision of the Income Tax Unit holding that certain payments of interest made by said A as administrator, which had accrued on notes of the decedent and which interest was deducted from the decedent's estate for estate tax purposes in determining the amount of the gross estate, are not allowable deductions from income in the return of the administrator.

In Solicitor's Memorandum 184 it was held that "salary earned by an individual in his lifetime and received by his estate after his death is taxable income of the estate and not of the decedent unless such decedent kept his accounts upon some basis 'other than that of actual receipts and disbursements,'" and this notwithstanding the salary claimed was a part of the gross estate of the decedent subject to estate tax as such. In an informal unnumbered memorandum in connection with a letter dated June 7, 1919, the Solicitor also held in answer to an inquiry that taxes assessed against a decedent, due and payable prior to his death, were properly deductible in the return made by the executor for the decedent's estate.

On the strength of these decisions it appears clear that if the decedent did not keep his accounts upon some basis other than that of actual receipts and disbursements the amount of interest paid by the administrator of the estate of B was properly deductible from the income received by the administrator. Attention is called, however, to the fact that only the accrued interest on outstanding obligations may be deducted, and where interest upon an old note has been capitalized by giving a new note, representing the aggregate of the old note with the interest accrued, only the amount of interest accrued upon the new note can be deducted, the new note representing payment of both principal and interest of the old. Upon the note, originally for $5x$ dollars, covering which, with accrued interest of $2x$ dollars a new note for $7x$ dollars was given, only the interest accrued on the new note is an allowable deduction.

The Committee therefore recommends that the decision of the Unit be modified along the lines indicated herein.

SECTION 214(a) 3.—DEDUCTIONS ALLOWED: TAXES.

SECTION 214(a) 3, ARTICLE 131: Taxes.

(See 3–20–687, sec. 214(a) 1, art. 111.) Deduction of New York State franchise tax in returns made on an accrual basis.

SECTION 214(a) 3, ARTICLE 131: Taxes. 3–20–688
(Also Section 222, Article 381.) O. D. 372

The Republic of Cuba imposes on all corporations operating sugar plantations in Cuba, a tax of a certain amount on each bag of sugar produced. Apparently this tax is based on production, not on income and is in the nature of an excise tax. Therefore a domestic corporation may deduct from gross income in its return to the United States Government the amount of such tax paid to the Cuban Government but may not claim the amount as a credit against the total tax due to the United States.

SECTION 214(a) 3, ARTICLE 131: Taxes. 5–20–713
(Also Section 214(a) 1, Article 111.) A. R. M. 26

> Held, that munitions taxes are properly chargeable against the income of the year in which the munitions are made and sold or otherwise disposed of, and that when the books of the manufacturer are kept upon an accrual basis, the amount of such taxes should be included as a deduction from income, and the liability therefore should appear upon the books of account of the company at the close of the taxable year.

It appears that the books of account of the M Company are kept upon an accrual basis, but that this company did not accrue upon its books at the close of its taxable year for 1916 an item of $30x$ dollars, representing munitions taxes for that year, to be paid during the year 1917.

The taxpayer contends that this item is a proper deduction for 1917, for the reason that the munitions tax was a special tax appli-

cable only for two years' operations, so that no consistent practice of accounting requires this liability to be accrued and placed upon its books for the year in which it was incurred.

The Committee finds itself utterly unable to agree with this conclusion of the taxpayer. Every consistent practice of accounting requires the establishment and setting up of all liabilities of any nature whatsoever, whenever such liabilities are known or can be accurately determined. Any departure from this well-recognized and established practice is in itself a departure from consistency. To the extent that this practice is neglected or ignored, the books of account are manifestly and undeniably in error. Any statement or balance sheet prepared from them would not be a statement of facts, and any income account would not reflect the true income of the company.

That this taxpayer fully recognizes this principle is demonstrated by the fact that the munitions taxes for the taxable year 1917 were so accrued and established as a liability in ascertaining its net income for 1917. It appears, therefore, that the taxpayer is estopped from asserting that the practice which it recognizes as proper for the taxable year 1917 was not also the proper practice for the previous taxable year.

Therefore, the Committee concurs in the opinion of the Income Tax Unit that inasmuch as this corporation kept its books on an accrual basis for 1916 and 1917, the munitions taxes paid in 1917 for the year 1916 should be accrued and deducted in ascertaining its taxable net income for the year 1916, and that the munitions taxes for 1917 were properly treated by the corporation in ascertaining its taxable net income for the latter year.

SECTION 214(a) 3, ARTICLE 131: Taxes. 5-20-714
O. D. 387

The tax imposed on 1918 income, under the bonus law of the State of Wisconsin, passed by the State legislature in September, 1919, does not constitute an allowable deduction in Federal income tax returns for 1918, and amended returns for that year can not be accepted; however, such tax paid in 1919, is an allowable deduction in the taxpayer's return for 1919.

SECTION 214(a) 3, ARTICLE 131: Taxes. 5-20-715
O. D. 388

A taxpayer whose books are kept on the receipts and disbursements basis may deduct from gross income on his 1919 return automobile taxes levied against him by the State of Iowa for 1919 and 1920, provided he actually paid such taxes during 1919. If the books of the taxpayer are kept on the accrual basis, then only the amount of such tax applicable to the year 1919 may be taken as a deduction in preparing his 1919 income tax return, and the amount which represents the 1920 tax may be deducted on such taxpayer's 1920 return, notwithstanding the fact that he actually paid the tax for both years in 1919.

SECTION 214(a) 3, ARTICLE 131: Taxes. 8-20-754
(Also Section 214(a) 1, Article 111.) S. 1305
(Also Section 234, Article 561.)

INCOME TAX—REVENUE ACT OF 1916, AS AMENDED BY THE REVENUE ACT OF 1917.

A corporation making a return for a fiscal year ending during the calendar year 1917 but prior to October 3, is not entitled to deduct from gross income both the Federal income tax paid prior to January 1, 1917, and the income tax accrued on its books of account during the months of the fiscal year falling within the calendar year 1916. Law Opinions 341 and 360 explained.

Reference is made to a memorandum of December 15, relative to the deduction of Federal income taxes by the M Company, whose fiscal year ended June 30, 1917. This company took advantage of the provisions of the 1913 law and established a fiscal year ending June 30. In its return for its fiscal year ending June 30, 1917, it claims the right to deduct from gross income the amount of the Federal income tax which it paid in November, 1916, upon its net income for the fiscal year ending June 30, 1916, and in addition the income taxes which accrued month by month for the last six months of the calendar year 1916.

The Acts of August 5, 1909, and October 3, 1913, did not provide for a return of income upon a scientific accounting basis. They simply provided that from the amount of the income received certain amounts paid should be deducted and the result should constitute the net income. Corporations contended from the first that their books of account were not generally kept upon a receipt and payment basis and that the amount of tax realized by the Government would not be materially changed if the companies were to make returns upon the basis of their books of account. This office therefore ruled in T. D. 1742 that amounts could be deducted from gross income if they were so entered upon the taxpayer's books of account as to constitute a liability against the assets. The substance of the ruling above referred to was embodied in article 158 of Regulations 33, dated January 5, 1914. It is there stated:

It is immaterial whether the deductions except for taxes and losses are evidenced by actual disbursements in cash, or whether evidenced in such other way to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets of the corporation making the return. Deductions for taxes, however, should be the aggregate of the amounts actually paid, as shown on the cash book of the corporation.

Article 156 of the same regulations provides:

Reserves for taxes can not be allowed, as the law specifically provides that only such sums as are paid within the year for taxes shall be deducted.

Following these regulations corporations generally made their returns of income upon the basis of their loss and gain accounts for all items except taxes. Many corporations and most railroad corporations deducted from gross income not the amount of interest paid on indebtedness but the amount of interest accrued. In other words railroad corporations made their returns of income upon the basis of their accounts as kept in accordance with the rules of the Interstate Commerce Commission. Revenue agents examining the

books of account of railroad companies generally required such companies to amend their returns and allowed them to deduct from gross income only the amount of interest paid upon indebtedness. Railroad companies stoutly protested and the point was finally settled by T. D. 2625, which authorized railroad companies under the 1913 law to deduct the interest accrued within the taxable year.

It is assumed that the M Company followed the regulations of the office in making returns of net income under the 1913 law and that for each of the taxable years 1913, 1914, and 1915 it deducted payments for expenses as shown by its books of account and deducted not the amount of taxes shown in its financial statements as having accrued but the amount actually paid. Thus, for the fiscal year ending June 30, 1916, it deducted the amount of the Federal income tax which it paid presumably in November, 1915. In making its return for the fiscal year ending June 30, 1917, it would also naturally deduct the amount of tax which it actually paid in November, 1916. The Revenue Act of 1916, provided, however, in Section 13(d) that a corporation keeping its accounts "upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income may, subject to regulations made by the Commissioner of Internal Revenue * * * make its returns upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned." This provision of law had application to returns made by corporations for the calendar year 1916 or for a fiscal year ending in 1917.

If it had not been for the provision of the Revenue Act of 1917, prohibiting corporations from deducting from gross income, "Income and excess profits taxes," the M Company would clearly have been entitled to deduct from its gross income upon its return made for the fiscal year ending June 30, 1917, the full amount of taxes which had accrued from July 1, 1916, to June 30, 1917. If, however, in such a case it had deducted the taxes accrued it would not have been entitled to deduct the taxes which it paid in November, 1916, upon its return of income for the fiscal year ending June 30, 1916. To permit it to make such a deduction would not have produced its true net income, for it would have allowed the company to deduct two years' taxes upon a return covering only a single year.

Law Opinion 341 provides:

> Income and excess profit taxes paid by a corporation having a fiscal year ending prior to October 3, during the calendar year 1917 and within its fiscal year ending in 1917, are not allowable deductions from its gross income for such fiscal year. Income taxes paid within that fiscal year and during the calendar year 1916 are allowable deductions from such gross income.
>
> The net income of a corporation for its fiscal year ending within the calendar year 1917, prior to October 3, should be credited with the excess profits tax assessed upon it for such part of that fiscal year as is included within the calendar year 1917.

Law Opinion 360 provides:

> A reserve actually maintained during the year 1916 to meet taxes payable in 1917 upon income for the year 1916 is an allowable deduction for the year 1916 from the gross income of a corporation keeping its books on an accrual basis.

Law Opinion 341 lays special stress upon the point that the calendar year is the basis for the income tax. The provisions authorizing the designation of fiscal years are merely concessions to taxpayers

for their convenience in accounting, and are not intended to affect the general scheme of taxation or to relieve taxpayers of liability to tax. Therefore it was held, that a corporation making a return for a fiscal year ending in 1917, prior to October 3, could deduct from gross income the actual taxes paid by the corporation during the calendar year 1916. If this were not so, the corporation would have been prejudiced by the fact that it had established a fiscal year and was not entitled to deduct any part of the Federal income tax which it had paid upon at least a part of its income falling within the calendar year 1915. The opinion appears to be sound.

Law Opinion 360 contemplated the case of a corporation keeping its books of account upon an accrued basis. Under the provision of section 13(d) of the Revenue Act of 1916, a corporation was entitled to deduct taxes which had accrued, and the law opinion takes the position that the Revenue Act of 1917 must not be construed to take away from a corporation any privilege which it had under the 1916 law with reference to its 1916 income. The application of this law opinion to the case of the M Company would entitle such company to deduct from its gross income in its return for its fiscal year ending June 30, 1917, the amount of the income tax which it actually accrued under the 1916 law up to December 31, 1916. This would not, of course, necessarily be one-half of the amount of the income and excess profits taxes payable for the fiscal year of the corporation ending June 30, 1917. The corporation was not subject to any excess profits tax upon its income which accrued during the calendar year 1916, and the tax deductible upon an accrual basis would be only the tax of 2 per cent upon the net income of the corporation for the first six months of its fiscal year ending June 30, 1917.

If the M Company claims the right to deduct from its gross income for the fiscal year ending June 30, 1917, the income tax paid during the month of November, 1916, it must be denied the right to deduct any portion of the income tax which accrued during the fiscal year ending June 30, 1917. The right of the company to deduct the income tax paid during November, 1916, must be on the basis that its return for the fiscal year ending June 30, 1917, was made upon a basis of actual cash payments. If, in point of fact, the company's return was made upon an accrued basis, it is not entitled to deduct the income tax paid during the month of November, 1916, because upon such a basis the tax paid in that month was an expense of the preceding fiscal year. It would, however, in such event, be entitled to deduct the Federal income tax actually accrued upon its books of account from the period July 1 to December 31, 1916.

SECTION 214(a) 3, ARTICLE 131: Taxes. 9–20–770
A. R. M. 29

MUNITION MANUFACTURER'S TAX, REVENUE ACT OF 1916.

In the instant case of the M Company, but applicable in establishing a general principle, the Unit submits to this Committee the following questions:

(1) Since the books of the above-mentioned corporation are kept on the accrual basis, is it proper for it to accrue munitions taxes for the years 1916

and 1917 and deduct as an expense the amount accrued during each year in its munitions tax return for that year before the final computation of the munitions tax is made?

(2) Should the munitions tax as finally computed be allowed as a deduction in the income tax return for the year in which the tax is accrued, or for the year in which the tax is actually paid?

(3) Assuming that the answer to question (1) is "yes," would the algebraic method outlined in subsequent paragraphs be the correct procedure for the computation of the munitions tax for each year?

Referring to the third question above, the "algebraic method outlined" produces the following formula:

$$X=\frac{RA}{1+R}$$

wherein X represents the amount of munitions tax to be determined, R represents the rate of munitions tax (12½ per cent) and A represents the "net profits from munitions operations before deducting accrued munitions tax." Translated into words this formula signifies that the munitions tax is to be determined by multiplying the net profits from munitions operations by the rate of munitions tax (12½ per cent) and dividing the product by 1.125, which has the effect of simultaneously computing the amount of the munitions tax, deducting it from the net income from munitions and determining the tax upon the amount of net income as reduced by the amount of the tax itself.

Considering and answering questions 1 and 3 together and assuming, for the moment, that the first question were answered in the affirmative, the algebraic method suggested for determining, under the conditions as stated, the amount of the munitions tax is correct; but the Committee is of the opinion that the reasoning underlying that method is fundamentally fallacious, the fallacy consisting in computing the tax upon the quantity "$A-X$" where X is the amount of tax to be determined.

The "munition manufacturer's tax" is imposed by Title III of the Act approved September 8, 1916, of which Act paragraph (1) of section 301 is as follows:

> That every person manufacturing (six specified classes of munitions) shall pay for each taxable year, in addition to the income tax imposed by Title I, an excise tax of twelve and one-half per centum upon the entire net profits actually received or accrued for said years from the sale or disposition of such articles manufactured within the United States.

It will be observed that this section provides for the levying of an excise tax "upon the *entire net profits* actually received or accrued * * * from the sale or disposition of such (specified) articles manufactured within the United States."

Section 302 of the Act specifies the manner in which such net profits are to be computed under the provisions of Title III, and paragraph (d) allows as deductions "taxes of all kinds paid during the taxable year with respect to the business or property relating to the manufacture"; but it is not conceivable to this Committee that Congress intended to include in the provisions of this paragraph, and thereby to allow as a deduction, the identical munitions tax for the determination of which and the manner of the determination of which sections 301 and 302 provide. The munitions tax is an excise tax of which the measure is "the *entire* net profits actually received or

accrued * * * from the sale or disposition" of such munitions. The Committee is of the opinion that it would be a forced construction of the law and at variance with the reasonable interpretation thereof to include among the deductions permitted by law the very tax itself for the determination of which section 302 of the Act provides.

The Committee, therefore, is of the opinion that the questions propounded are properly answered below:

(1) It is not proper for a corporation to accrue munitions taxes for the years 1916 and 1917 and to deduct as expenses the amount so accrued during each year in its munitions tax return for that year before the final computation of the munitions tax is made.

(3) Having answered the first question in the negative, the algebraic method outlined becomes unnecessary and the munitions tax should be computed by multiplying the net profits from munitions operations by the rate (12½ per cent) of the munitions tax.

(2) For the purpose of determining taxable net income in the case of manufacturers of munitions, the munitions tax as finally computed not only should be allowed but ought to be insisted upon as a deduction in the income tax return (but *not* in the munitions tax return) for the year in which the tax is accrued, irrespective of the year in which the tax is actually paid.

SECTION 214(a) 3, ARTICLE 131: Taxes. 20–20–936
O. D. 505

The New York State personal income tax law, passed May 14, 1919, provides for the imposition of an annual tax upon income, and concludes with the statement that "such tax shall first be levied, collected, and paid in the year 1920, upon and with respect to the taxable income for the calendar year 1919, or for any taxable year ending during the year 1919."

A taxpayer of the State of New York who keeps his accounts upon the accrual basis, may in rendering his Federal income tax return for 1919, deduct the accrued tax for his fiscal year ended in 1919, imposed by the New York State personal income tax law, provided such fiscal year ended subsequent to May 14, 1919, the date of passage of the State taxing act. In case his fiscal year ended prior to May 14, the accrued tax would not be deductible in his Federal income tax return for 1919 since it was not a known liability at the time of closing his accounts for such fiscal year.

In the event of judicial interpretation of the New York State personal income tax law which would have the effect of changing the individual's tax liability thereunder it would be necessary for him to file an amended return for Federal income tax purposes.

SECTION 214(a) 3, ARTICLE 131: Taxes. 24–20–1002
(Also Section 214(a) 4, 5, 6, Article 141.) A. R. M. 57

MUNITION MANUFACTURER'S TAX, REVENUE ACT OF 1916.

The opinion of the Committee is requested by the Unit with reference to the propriety of certain deductions for the purpose of

determining the munitions tax payable by a taxpayer for the calendar year 1917.

Two points are involved: (1) the deduction of an amount of x dollars representing the payment in July, 1917, of the munitions taxes which accrued for the calendar year 1916; and (2) the deduction of a loss of $8x$ dollars on the sale of the stock of the N Company, a subsidiary company incorporated in a foreign country.

(1) In discussing this point the Unit refers to section 302(d) of the Revenue Act of 1916, and this Committee's Memorandum 29. This memorandum was written in answer to three specific questions propounded by the Unit. It has no direct application to the case now under consideration and should not be construed to prevent the deduction on the munitions tax return for 1917 of munitions taxes actually paid in that year for the year 1916.

In Memorandum 29 the Committee held that munitions taxes computed for the years 1916 and 1917, are proper deductions for determining the income taxes of those respective years; but *not* of the munitions taxes for the years in which such taxes accrued.

Paragraph (d) of section 302 of the law allows as deductions in computing net profits—

> Taxes of all kinds paid during the taxable year with respect to the business or property relating to the manufacture

of munitions. Under this section of the law taxes of *all kinds* are deductible; but in order to be deductible, they must have been levied "with respect to the business or property relating to the manufacture" of munitions and they must have been "paid during the taxable year."

Memorandum 29 is in accord with this provision of the law and its effect is to prevent, in computing the munitions tax for 1916 and 1917, the inclusion as a deduction of the tax itself for each respective year; but it does not prevent the deduction, in the year in which accrued, of such taxes in computing the *income tax* for those years. Thus, in 1916, no munitions tax can be deducted, for none was *paid* in that year; for 1917, the munitions tax for 1916, paid in 1917, is a proper deduction; for 1918, there was no munitions tax and consequently the munitions tax for 1917, although paid in 1918, can not be deducted, for there was nothing from which such deduction could be made.

Therefore, in response to the first question, the opinion of the Committee is that the amount of x dollars representing the munitions taxes accrued for the calendar year 1916 is a proper deduction in computing the munitions tax for the calendar year 1917, since it was paid in that year.

(2) The deduction of a loss of $8x$ dollars on the sale of the capital stock of the N Company is sought upon the ground that that corporation was a subsidiary of the taxpayer which owned all of its capital stock and advanced all the necessary funds for its plant, equipment, and operating expenses, amounting in all to $10x$ dollars, for which it took the company's stock. When the N Company was liquidated the taxpayer sold all its stock for $2x$ dollars, and it claims the balance of $8x$ dollars as a loss deductible in computing its munitions tax for the calendar year 1917.

Section 301, paragraph (1) of the Act above referred to provides:

> That every person manufacturing [six specific classes of munitions] shall pay of each taxable year * * * an excise tax of twelves and one-half per centum upon the entire net profits actually received or accrued for said year from the sale or disposition of such articles manufactured *within the United States* * * *.

From this provision of the law it appears that no munitions tax could have been levied upon the N Company, nor upon any profits which might have been derived from it by the parent company, the M Company, since all munitions manufactured by the N Company were manufactured abroad and not *within the United States.*

Section 302(e) provides for the deduction, in the computation of the munitions tax, of—

> Losses actually sustained within the taxable year in connection with the business of manufacturing such articles;

but since these losses are permitted as deductions only for the purpose of computing the munitions tax it is certain that they can not be allowed as deductions to the parent company where no munitions tax could have been levied under the law upon the articles manufactured.

In response to the second question, it is the opinion of the Committee that no deduction can be allowed representing the loss to the M Company on the sale of the capital stock of its subsidiary.

SECTION 214(a) 3, ARTICLE 133: Taxes for local benefits. 3–20–689
O. D. 373
(Also Section 214(a) 1, Article 109.)

Assessments for local benefits paid by a tenant for his landlord according to agreement are held to be additional rent paid by the tenant, and therefore deductible from his gross income, provided the tenant uses the property for business purposes. The amount so received by the landlord is taxable income to him, but because of its nature is not an allowable deduction from his gross income.

SECTION 214(a) 3, ARTICLE 134: Inheritance taxes. 16–20–875
Op. A. G. 1
(Also Section 219, Article 341.)

DEPARTMENT OF JUSTICE,
Washington, April 10, 1920.

Hon. DAVID F. HOUSTON,
Secretary of the Treasury,
Washington, D. C.

DEAR MR. SECRETARY: I have the honor to acknowledge receipt of the letter of your predecessor, dated January 15, 1920, requesting an opinion on the following question:

> Is the Federal estate tax deductible under the provisions of section 214(a) 3 of the Act of February 24, 1919, in computing the income received by estates of deceased persons for the purpose of taxes under the provisions of section 219(a)?

I have no hesitancy in answering this question in the negative. In so doing, the following provisions of the Revenue Act of February 24, 1919, are involved:

Section 210 imposes upon the net income of individuals a normal tax for the year 1918 of 6 per cent on the first $4,000 and 12 per cent on the remainder. Section 211 imposes on the net income of individuals in excess of $5,000 an additional or surtax, which is graduated and ranges from 1 per cent of the amount by which the net income exceeds $5,000 and does not exceed $6,000 to 65 per cent of the amount by which the net income exceeds $1,000,000. Section 212 defines net income as what is left after making certain deductions from gross income. Section 214 enumerates these deductions, the purpose of which is to arrive at the amount which represents the actual gain or profit of the individual during the tax year. Among these deductions is the following:

> 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; or (*b*) by the authority of any of its possessions * * *; or (*c*) by the authority of any State or Territory * * *.

Section 219(*a*) is:

> 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—
>
> (1) Income received by estates of deceased persons during the period of administration or settlement of the estate;
>
> * * * * * * *

Subsection (*b*) provides that—

> The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212,

with one exception not material to the present question. Subsection (*c*) provides that the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216—that is, an exemption of $1,000. It also provides that in determining the net income of an estate during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir, or beneficiary. The so-called estate tax is imposed by sections 400 et seq. Section 401 is:

> That * * * a tax equal to the sum of the following percentages of the value of the net estate * * * is hereby imposed upon the transfer of the net estate of every decedent dying after the passage of this Act, * * *.

Section 403 provides for determining the amount of the net estate. In substance, all debts and expenses of administration are to be deducted, together with an exemption of $50,000, the remainder being the net estate as that term is used in the Act. The tax is 1 per cent of the amount of the net estate not in excess of $50,000, and gradually increases until it reaches 25 per cent of the amount by which the net estate exceeds $10,000,000. By section 404 the executor is required to make returns of the estate upon which the tax is to be computed. Section 406 is:

> That the tax shall be due one year after the decedent's death; but in any case where the Commissioner finds that payment of the tax within one year after the decedent's death would impose undue hardship upon the estate, he may grant an extension of time for the payment of the tax for a period not to exceed three

years from the due date. If the tax is not paid within one year and 180 days after the decedent's death, interest at the rate of 6 per centum per annum from expiration of one year after the decedent's death shall be added as part of the tax.

By other sections of the Act the tax is made a lien upon the gross estate, but if collected out of property passing to any person other than the executor it is provided that such person shall be entitled to reimbursement or to a just and equitable contribution by persons whose interest in the estate would have been reduced if the tax had been paid by the executor. Section 400 is, in part:

The term "executor" means the executor or administrator of the decedent, or, if there is no executor or administrator, any person who takes possession of any property of the decedent.

It is obvious that the result of the various sections above referred to is that every individual is liable for a tax on the net income accruing to him up to the moment of his death; that upon his death his estate passes to others, either directly or through an executor or administrator, but that in the act of passing it is diminished to the extent of the Federal estate tax; that the estate received by or for those succeeding to it is the estate which the decedent owned at the time of his death less the amount by which it has been diminished through the imposition of the tax on its transfer; and that the income derived from the estate thus diminished is the income which is subject to tax during the period of administration or settlement.

The inheritance tax is entirely separate and distinct from the income tax. In substance, the Government collects a tax on the income accruing up to the moment of death. It then takes out of the estate a certain part as a transfer tax. The remainder passes and becomes the estate, the income of which is taxable while it is being administered. When the estate passes into the possession of an executor he holds in trust for the United States that portion which is required to be deducted as a transfer tax. The remainder is the estate which he holds in trust for creditors and beneficiaries, and the income of which is taxable. When he pays to the Government that which he has been holding in trust for it he pays nothing out of the estate, the income of which is subject to tax. The law separates this part of the original estate from that part which is to be treated as the estate for purposes of income taxes.

The so-called estate tax is, in terms, imposed upon the transfer of the estate. It is not a tax upon the property, but it is one of the form of taxes known as death duties. In *Knowlton* v. *Moore*, 178 U. S., 41, 56, speaking of taxes of this kind, it was said:

Although different modes of assessing such duties prevail, and although they have different accidental names, such as probate duties, stamp duties, taxes on the transaction, or the act of passing of an estate or a succession, legacy taxes, estate taxes, or privilege taxes, nevertheless tax laws of this nature in all countries rest in their essence upon the principle that death is the generating source from which the particular taxing power takes its being and that it is the power to transmit, or the transmission from the dead to the living, on which such taxes are more immediately rested.

And speaking further of inheritance and legacy taxes the court, at page 54, quoted from *United States* v. *Perkins*, 163 U. S., 625, as follows:

Thus the tax is not upon the property, in the ordinary sense of the term, but upon the right to dispose of it, and it is not until it has yielded its contribution to the State that it becomes the property of the legatee.

In the case last referred to it was held that an estate or transfer tax imposed by a State was valid when applied to a legacy to the United States Government, the court saying:

> 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 assents to a bequest of it.

In the present case the amount of the transfer tax is computed upon the net value of the estate passing, and it is expressly provided that it is collectible whether the property passes directly into the possession of the beneficiary or first passes through the hands of an executor or administrator. To illustrate, we may take an extreme case: Suppose a man dies intestate the owner of a large estate consisting exclusively of real property and leaving but a single heir. The title to his property passes directly to the heir. What the heir really receives is an equity in the property measured by the difference between its value and the amount of indebtedness to which it is subject. If there is indebtedness he may, if he chooses, pay it off and thus become the owner of the entire property. What has passed to him, however, by the death of the decedent is still the difference between the value of the property and the indebtedness which he has seen fit to pay. The Federal Government, however, has imposed a transfer tax which still further reduces the value of his equity. Again he may, if he chooses, pay this in order to keep the property intact. In that event there will have passed from the decedent an estate the value of which was the difference between the value of the property and the indebtedness to which it was subject. In the act of passing, however, this value has been diminished to the extent of the Federal estate tax, and when it reaches the heir it is what passed from the decedent less the amount of the estate tax. The heir, however, takes possession of the property immediately upon the death of the decedent, and from that moment receives the income arising from it. When it comes to making his income tax report he does not include the value of the property received, but he does include all income derived from it. If he should claim the right to deduct the amount of the inheritance tax, the answer would be that he has not, in fact, paid that tax, but the law treated it as deducted from the estate before it reached him. Having been paid out of property which never came to or belonged to him, he can not fairly claim to have paid it or to be entitled to a deduction for it.

The same principle applies when the property of a decedent passes into the hands of an executor or administrator. The executor receives the income derived from the property under his control. Out of this he is entitled to deduct, with certain exceptions, taxes paid by him. It is in his capacity as the representative of those ultimately entitled to the estate that he is subject to income tax. By virtue of the Federal estate tax, he may be said to act in a dual capacity. He must first take possession of that part of the estate which the Government has reserved to itself as a transfer tax. As to this he takes possession for the Government, and his sole duty is to turn it over to the Government. What comes to his hands, as the representative of the beneficiaries of the estate, is what is left of the original estate after deducting this tax. When, therefore, he pays the estate tax, he does not pay it out of the estate which in his hands

is subject to taxation, but simply delivers to the Government that which by law was taken out of the estate before it passed to him as the representative of the ultimate beneficiaries.

In a recent case before District Judge Augustus N. Hand (*Prentiss* v. *Eisner*, 260 Fed. 589, 590) the right was asserted to deduct from gross income the amount of transfer taxes imposed by the State of New York. The taxes in question were exactly like the Federal estate tax, and, as has been seen, taxes imposed by the State are deductible in the same way as those imposed by the Federal Government. Judge Hand, however, held that the transfer taxes in question were not deductible. In doing so he quoted from the case of *Matter of Swift*, 137 N. Y. 77, as follows:

> 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.

After quoting this, Judge Hand said:

> 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 received, properly speaking, an equity. He can pay the tax and get the land freed from the incumbrance, 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.

For the reason, therefore, that the inheritance tax is not in any proper sense paid out of the estate which is liable for income tax, I am of opinion that that tax is not deductible under the provisions of section 214(a) 3 of the Act of February 24, 1919, in computing the income of estates of deceased persons for the purpose of taxes under the provisions of section 219(a).

Respectfully,

C. B. AMES,
Acting Attorney General.

SECTION 214(a) 4, 5, 6.—DEDUCTIONS ALLOWED: LOSSES.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses. 3-20-690
O. D. 374

In the case of orchards and vineyards acquired subsequent to March 1, 1913, and later destroyed, any deduction for loss should be confined to the amounts of capital originally invested in the growing trees and in the new nursery stock which was totally destroyed and the amount expended from date of acquirement to date of destruction in an endeavor to bring such trees and stock to an income-producing stage, eliminating all expenditures on account of permanent improvements or on account of trees and vines the growth of which was merely retarded and not entirely destroyed.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses. 3–20–691
O. D. 375

If a taxpayer purchases royalty interests in tracts of oil land (not including title to the land itself) and such interests prove worthless, as evidenced by all wells drilled proving dry or failing after producing very small quantities of oil, the loss sustained is an allowable deduction from gross income.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses. 4–20–703
(Also Section 204, Article 1601.) O. D. 380

An individual sustained a loss in 1918, due to the failure and liquidation of two corporations in which he owned stock.

Held to be merely a loss on securities rather than a business operating loss, as contemplated in section 204 of the Revenue Act of 1918, and deductible only in his return for 1918.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses. 7–20–739
T. D. 2972

Article 141 of Regulations 45 is hereby amended to read as follows:

ART. 141. *Losses.*—Losses sustained during the taxable year and not compensated for by insurance or otherwise are fully deductible (except by nonresident aliens) if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or from theft. They must usually be evidenced by closed and completed transactions. In the case of the sale of assets the loss will be the difference between the cost thereof, less depreciation sustained since acquisition, or the fair market value as of March 1, 1913, if acquired before that date, less depreciation since sustained, and the price at which they were disposed of. See section 202 of the statute and articles 39–46 and 1561. When the loss is claimed through the destruction of property by fire, flood, or other casualty, the amount deductible will be the difference between the fair market value of the property as of March 1, 1913, if acquired before that date, or if acquired on or after that date, its cost, and the salvage value thereof, after duducting from such cost, or such value as of March 1, 1913, the amount, if any, which has been or should have been set aside and deducted in the current year and previous years from gross income on account of depreciation and which has not been paid out in making good the depreciation sustained. But the loss should be reduced by the amount of any insurance or other compensation received. See articles 49 and 50. A loss in the sale of an individual's residence is not deductible. Losses in illegal transactions are not deductible. Where a person gives property away, or is divested thereof by death, no realization of loss results therefrom.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses. 9–20–771
A. R. M. 31

In 1914 a corporation purchased certain merchandise abroad. The merchandise while in transit was requisitioned and seized by German authorities, war having broken out subsequent to the shipment of the merchandise. The corporation presented to the Imperial Indemnity Commission in Berlin a claim for the value of the merchandise so taken, and this claim had not been acted upon by that commission when war was declared between the United States and

Germany. During 1915 the commission called for further evidence principally as to the organization of the company and its right to file a claim, etc., of a routine character.

The company not having secured settlement of this claim charged the entire amount off as a loss or bad debt in 1917 on the ground of declaration of war between America and Germany. The Committee believes that it is abundantly established by the quotations from authorities on international law contained in a memorandum submitted with the case that:

> Debts due by one belligerent state to the citizens of the other are not extinguishable by the war.

It is, therefore, of the opinion that the question of whether or not the company has suffered any loss through this requisition and seizure by the German Government is not and can not be determined at the present time, and is, therefore, of the opinion that the transaction not being closed the company is not entitled to take a deduction of the amount of this claim as a loss in its return of income for 1917.

SECTION 214(a) 4, 5, 6, Article 141: Losses. 18–20–899
(Also Section 212, Article 21.) O. D. 486

Under New York State laws, a safe-deposit company is required to wait two years before opening any safe-deposit box for nonpayment of rent. The fact that no rental is paid during these years and it is impossible of collection does not permit the company to take a deduction from gross income in an amount equal to the rental value of any deposit box which it by law is prevented from opening, unless the company's books are kept on an accrual basis and such amount has actually been accrued.

That a taxpayer might derive greater profits if it were not for restrictions placed upon his activities by Federal or State laws has no bearing on his returns for Federal income tax purposes.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses. 19–20–918
A. R. R. 96

REVENUE ACT OF 1917.

> Held, that a loss resulting from the sale of taxpayer's residence in 1917 is not a loss incurred in business or trade. Recommended that the action of the Unit in disallowing the amount of such loss be sustained.

The Committee has had under consideration the appeal of A from the action of the Income Tax Unit in disallowing an amount claimed as a loss in his income tax return for 1917.

Claim for this deduction is made on the ground that the loss is a business loss and therefore not limited by the provisions of the Revenue Act of 1917 holding that losses not incurred in trade or business may be allowed only to the extent that there are incidental profits from which to deduct them. This loss was incurred through the sale of A's residence and is claimed as a business loss because of

acceptance of a business proposition necessitating his removal to another part of the country.

The language of the 1917 Act, section 5, paragraph (a) fourth, is as follows:

> Losses actually sustained during the year incurred in his business or trade.

In the opinion of the Committee a loss arising under the circumstances in this case can not be regarded as a loss incurred in business or trade, and it therefore recommends that the action of the Unit in disallowing the loss be sustained.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses. 22–20–969
O. D. 526

A ring was lost by its owner and owing to the circumstances attending the loss he is in doubt as to whether it was stolen or merely misplaced or lost from his finger.

Unless he can establish the fact that the ring was stolen no deduction can be allowed on account of the loss.

Such a loss does not come within the meaning of the term "other casualty" as used in section 214(a) 6 of the Revenue Act of 1918. This term embraces losses arising through the action of natural physical forces and which occur suddenly, unexpectedly, and without design of the one suffering the loss.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses.

(See 24–20–999; sec. 213(b), art. 73.) Loss sustained on sale of property deeded by husband to wife and reconveyed to him prior to sale.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses.

(See 24–20–1002; sec. 214(a) 3, art. 131.) Loss from sale of foreign subsidiary as deduction in computing munitions tax of parent concern.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses. 25–20–1015
O. D. 555

A mother who is indebted to her son discharges the obligation by transferring to him stocks which cost her $8x$ dollars, but which had a market value at date of transfer of $6x$ dollars, the amount of the debt.

Held, that if the transfer of the stock from mother to son was a bona fide transaction in payment of an enforceable obligation which the son held, the loss sustained by the mother is deductible under section 214(a) 5 of the Revenue Act of 1918, the amount of the loss being the excess of the cost of the stock, if acquired by the mother on or after March 1, 1913, or its value on that date if acquired prior thereto, over the amount of the debt and unpaid interest.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses. 25-20-1016
T. D. 3029

INCOME TAX: ACT OF OCTOBER 3, 1913, SECTION II—DEDUCTIONS.

1. A member of a firm engaged in the business of manufacturing is not entitled to deduct from his gross income a loss sustained by him upon the sale of shares of stock.

2. The language "losses incurred in trade" must be construed as meaning losses incurred in the actual business of the taxpayer as distinguished from isolated transactions.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

Eugene W. Mente, Plaintiff in Error, v. Mark Eisner, Collector of Internal Revenue, Defendant in Error.

[May 3, 1920.]

WARD, Circuit Judge: Section II, subdivision 2(b), of the Act of October 3, 1913, provides that in computing net income for purposes of normal tax there shall be allowed as a deduction:

* * * Fourth: Losses actually sustained during the year incurred in trade, or arising from fires, storms, or shipwreck and not compensated for by insurance or otherwise.

Mente, a member of the firm of Mente & Co., engaged in the business of manufacturing jute bags and bagging, cotton bags, and materials for covering cotton bales, filed his income returns for the year March 1 to December 31, 1913, and for the whole year of 1914. He had for some three years been buying and selling cotton on the Cotton Exchange for his individual account, in no way connected with the business of Mente & Co., and he deducted from his gross income in each year losses sustained in the year resulting from these transactions as "losses incurred in trade."

Eisner, as Collector of Internal Revenue for the third district of the State of New York, assessed an additional tax upon these deductions, which Mente paid under protest, taking an appeal to the Commissioner of Internal Revenue under sections 3220 and 3228, United States Revised Statutes, and the Regulations of the Secretary of the Treasury in pursuance thereof, who rejected his claim. Thereupon Mente began this action against Eisner as collector to recover the amounts so paid, with interest and costs.

Treasury Decision 2090, dated October 14, 1914, reads:

Loss, to be deductible, must be an absolute loss, not a speculative or fluctuating valuation of continuing investment, but must be an actual loss, actually sustained and ascertained, during the tax year for which the deduction is sought to be made; it must be incurred in trade and be determined and ascertained upon an actual, a completed, a closed transaction. The term "in trade" as used in the law, is held to mean the trade or trades in which the person making the return is engaged; that is, in which he has invested money otherwise than for the purpose of being employed in isolated transactions, and to which he devotes at least a part of his time and attention. A person may engage in more than one trade and may deduct losses incurred in all of them; provided that in each trade the above requirements are met. As to losses on stocks, grain, cotton, etc., if these are incurred by a person engaged in trade to which the buying and selling of stocks, etc., are incident as a part of the business, as by a member of a stock, grain, or cotton exchange, such losses may be deducted. A person can be engaged in more than one business, but it must be clearly shown in such cases that he is actually a dealer, or trader, or manufacturer, or whatever the occupation may be, and is actually engaged in one

or more lines of recognized business, before losses can be claimed with respect to either or more than one line of business, and his status as such dealer must be clearly established.

Both parties having moved for the direction of a verdict Judge Grubb directed a verdict in favor of the defendant.

We think that the language "losses incurred in trade" are correctly construed by the Treasury Department as meaning in the actual business of the taxpayer as distinguished from isolated transactions. If it had been intended to permit all losses to be deducted it would have been easy to say so. Some effect must be given to the words "in trade."

There is an inconsistency in making profits derived from such transactions a part of the taxpayer's gross income and on the other hand allowing him no deduction for losses. But tax laws are not required to be perfect or even consistent. It must be determined from the facts in each case whether or not the losses claimed to be deducted have been incurred in a business.

In this case the court must be taken to have found as matter of fact that these transactions in 1913 and 1914 did not constitute a business. Such a finding is binding upon us.

Judgment affirmed.

SECTION 214(a) 4, 5, 6, ARTICLE 141: Losses.

(See 25–20–1017; sec. 214(a) 7, art. 151.) Deductibility of losses determined after decedent's death.

SECTION 214(a) 4, 5, 6, ARTICLE 143: Loss of useful value.

(See 19–20–919; sec. 214(a) 8, art. 170.) Loss on sale of distilling plant, the salvage value of which was overestimated.

SECTION 214(a) 4, 5, 6, ARTICLE 144: Shrinkage in securities and stocks. 20–20–937 O. D. 506

A taxpayer who, prior to March 1, 1913, purchased bonds which had a market value as of March 1, 1913, above par, and which were redeemed at par in 1919, is entitled to deduct, as a loss in 1919, the difference between the market value on March 1, 1913, and the value received in 1919 upon maturity of the bonds.

SECTION 214(a) 4, 5, 6, ARTICLE 144: Shrinkage in securities and stocks. 21–20–954 L. O. 1035
(Also Section 233, Article 542.)
(Also Section 234, Article 564.)

INCOME TAX: ACT OF OCTOBER 3, 1913, SECTION G(b); REVENUE ACT OF 1916, SECTION 12(a) SECOND, SECTION 12(a) THIRD.

(1) Where a new corporation is organized in November, 1917, having the same stockholders with the same stockholdings as the old corporation, to which the old corporation transfers a large

amount of stocks and bonds at a loss, less than 1 per cent of the purchase price being paid in cash and the balance being paid for by notes secured by the stocks and bonds sold, possession of which was retained by the old corporation with power of sale in case of default, the new corporation having no other assets, the whole transaction will be regarded as a sham and a subterfuge to evade taxation and the loss will be denied. Article 148, Regulations 33, revised; article 144, Regulations 45; article 77, Regulations 41.

(2) A corporation derives no gain from a sale of its own stock previously purchased by it. Article 542, Regulations 45. But interest paid by stockholders on sales of stock on credit is taxable income.

(3) A manufacturer and dealer in merchandise which also deals largely in securities is entitled to deduct in full interest on indebtedness secured by such securities under section G(b) of Act of October 3, 1913. Such taxpayer is not entitled to deduct such interest in full under section 12(a) third of the Revenue Act of 1916, since it is not "a dealer only" in such securities. Law Opinion 621.

On examination of the income and excess profits tax returns of the M Company for the years 1912 to 1917, inclusive, several questions have been submitted for ruling. They will be treated separately.

(1) The deduction of a loss of $475x$ dollars on securities sold to N Company.

The M Company, engaged in an industrial business, owned certain stocks and bonds which it carried as liquid reserves available for opportune purchases of material. Most of these securities were listed on the New York Stock Exchange. They had cost (or were worth on March 1, 1913) $1{,}764x$ dollars; and the aggregate market value in November, 1917, was about $475x$ dollars less than this cost.

The stockholders of the M Company established a new corporation, hereinafter called the N Company, having the same stockholders with the same proportionate stock holdings as the M Company. The N Company then bought the stocks and bonds above mentioned from the M Company at market prices. It paid the M Company $12x$ dollars cash received from the sale of its capital stock and gave for the balance of the purchase price its demand notes bearing 6 per cent interest with these same securities as collateral. It had no other assets.

The apparent effect of this transaction is to entitle the M Company to a deduction of $475x$ dollars as a loss and to substitute admissible assets in place of inadmissible assets in the computation of invested capital.

Section 12(a) second, of the Revenue Act of 1916, permits a corporation to deduct from gross income "all losses actually sustained and charged off within the year and not compensated by insurance or otherwise." Regulations 33, revised, requires that losses must be "evidenced by closed and completed transactions."

ART. 148. *Shrinkage in securities.*—Corporation possessing securities such as stocks and bonds can not allowably deduct from gross income any amount claimed as a loss on account of the shrinkage in value of such securities through fluctuations of the market or otherwise; the only loss to be allowed in such cases is that actually suffered when the securities mature or are disposed of.

Substantially the same rule is repeated in article 144 of Regulations 45.

In the present transaction the identity of stock ownership of the two corporations has an important bearing on the question of de-

ductible loss. It is clear that under article 77 of Regulations 41 these corporations would be deemed affiliated and required to file a consolidated return for excess profits tax purposes. In such case the intercorporate transactions would be eliminated and no loss could be claimed, and there would be no change in invested capital because of this transaction. But even as to income tax it is clear that because of the identity of ownership of the stock the M Company continued to be in practical control of the N Company, and therefore in control of the securities themselves, so long as they remained in the hands of the N Company. This form of disposition by the M Company could have had no other purpose than to postpone the realization of gain or loss on these securities; otherwise, the M Company would simply have sold them on the stock exchange.

The retention of control, moreover, not only postponed liquidation but preserved the power of the M Company to undo the entire transaction and revest itself with the securities without violating anybody's substantial rights or interests. This power was made more effective by the retention of the custody of the securities as collateral to the notes with power to sell in case of default.

Besides retaining the practical control of the securities the M Company continued to carry the risk of their depreciation or loss; for although it had the absolute obligation of the N Company in the form of the latter's notes, the only assets behind the notes were these securities. The fact that the risk was theoretically lessened by the payment of $12x$ dollars cash is not very material since that payment, received indirectly from the company's own stockholders, was less than 1 per cent of the value of the securities.

As a result of the transaction, founded upon joint proportional ownership of the stock of both companies, the M Company retained substantially, and it was the whole purpose of the plan that it should retain, any advantage from a rise in value of these securities; and for the same reason it retained the risk of loss. It is, therefore, clear that disregarding form and looking at substance the realization of this loss has been postponed, and the transaction is not a closed and completed one. The whole procedure is obviously a sham and device to evade taxation.

In such cases the taxing authorities are not bound to recognize the forms adopted by the taxpayer to evade the imposition of taxes where such forms do not reflect an actual change in substance. (*H. M. Louden Sons Lumber Company* v. *Elmer Township* (Mich. 1900), 81 N. W. 965; *Montgomery* v. *Marshall County* (Iowa, 1911), 129 N. W. 329; *Sisler* v. *Foster* (Ohio, 1905), 74 N. E. 639; *Shotwell* v. *Moore* (1888), 129 U. S. 590.) The situation in this case does not indicate a bona fide change in legal relations made by the taxpayer to reduce taxes, but is a mere sham and subterfuge which accomplishes no actual or substantial change in conditions and leaves realization of gain or loss for future determination. The loss apparently realized here is a mere bookkeeping transaction and not the result of a bona fide sale or other disposition of the securities in question. The claim of the M Company for the deduction of the loss of $475x$ dollars must, therefore, be denied.

(2) The question of profits on the sale of stock to various employees.

The revenue agent included $4x$ dollars in gross income for 1912 and $47x$ dollars in gross income for 1917 on account of profits from the sale of treasury stock previously acquired by the company by purchase and resold to employees at an advanced price. The taxpayer claims that these so-called sales were in fact merely options, and that for that reason it should not be required to account for any gain. The nature of the agreement, however, becomes immaterial in view of article 542 of Regulations 45, promulgated since the revenue agent's report. That article provides in part:

> If, for the purpose of enabling a corporation to secure working capital or for any other purpose, the stockholders donate or return to the corporation to be resold by it certain shares of stock of the company previously issued to them, or if the corporation purchased any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction, and the proceeds of such sale will be treated as capital, and will not constitute income to the corporation.

This principle applies with equal force to the Revenue Act of 1916 as amended and to the Corporation Tax Act of 1909. No amount, therefore, should be included in gross income for 1912 or 1917 as profit from the sale of treasury stock.

(3) The inclusion in gross income for 1913, 1916, and 1917 of interest payable by the stockholders on agreements to purchase stock on credit is objected to by the taxpayer.

Agreements with stockholders similar to those previously mentioned gave such stockholders the right to purchase stock of the company for $2x$ dollars per share, with interest on the unpaid purchase price at 6 per cent per annum. Such an agreement with A made in 1912 matured in 1917, and the company accepted from A in payment of his obligations a promissory note of $26x$ dollars, $6x$ dollars of which represented interest. The company contends that this $6x$ dollars is not taxable income because it is the proceeds of the sale of stock and therefore exempt under article 542 of Regulations 45.

The contract made in 1912 provided that the stock should be paid for in 1917, with interest at 6 per cent per annum on the purchase price. There was evidently no obligation to pay the interest annually, but the five years' interest was payable at the maturity of the contract, so that if income at all it is income for 1917. In my opinion such interest is not part of the proceeds of the sale of stock. It is denominated interest by the parties. Payments on account at any time would to that extent stop the running of interest. This clearly shows that it is compensation for the use of money and not the selling price of the stock. It does not appear that the company's agreement to cancel the contract at the request of the stockholder and to return any payments made on the "purchase price" bound the company to waive the interest charged. That was due in any event. Furthermore, the stockholder was allowed to keep the dividends declared (the declaration of which was guaranteed), hence equitably should pay interest on the unpaid purchase price. This item of $6x$ dollars is therefore properly included in the income for 1917 as taxable interest.

Similar questions as to interest paid in 1913 and in 1915 are decided in the same manner and for the same reasons.

(4) The revenue agent disallowed certain deductions of interest for 1913, 1914, 1915, and 1916.

In each of these years the agent permitted the deduction of the full amount of interest deductible according to the terms of the statute then in force, unless a further allowance is permitted under the provisos quoted below. Section G(b) of the Act of October 3, 1913, reads in part:

Provided, That in case of indebtedness wholly secured by collateral the subject of sale in ordinary business of such corporation, joint-stock company, or association, the total interest secured and paid by such company, corporation, or association within the year on any such indebtedness may be deducted as a part of its expenses of doing business.

Section 12(a) third, of the Revenue Act of 1916, reads in part:

Provided further, That in the case of indebtedness wholly secured by property collateral, tangible or intangible, the subject of sale or hypothecation in the ordinary business of such corporation, joint-stock company, or association as a dealer only in the property constituting such collateral or in loaning the funds thereby procured the total interest paid by such corporation, company, or association within the year on any such indebtedness may be deducted as a part of its expenses of doing business, but interest on such indebtedness shall only be deductible on an amount of such indebtedness not in excess of the actual value of such property collateral.

This company was originally organized to buy, sell, and manufacture certain commodities, but in 1909 it greatly enlarged its powers so that it was expressly authorized to purchase, hold, and dispose of stocks, bonds, and other securities, and to borrow money on notes, bonds, or other debentures. The company contends that the items of interest disallowed are paid on indebtedness of the company wholly secured by collateral consisting of miscellaneous stocks and bonds of other corporations and in part by warehouse receipts for merchandise dealt in by the company. The revenue agent's report supports this statement of the taxpayer. It is said on page 4: "The company uses its stocks and bonds held in other companies as collateral." The company's returns from 1912 to 1917 disclose that large amounts were received as dividends and that from year to year such amounts fluctuated greatly, indicating in a general way considerable dealing in stocks. It would appear, therefore, that stocks and bonds are the subject of sale in the ordinary business of the corporation. This is, of course, true of the merchandise which in some cases furnished the security. It, therefore, seems clear that this is indebtedness wholly secured by collateral the subject of sale in the ordinary business of the corporation and that interest paid thereon is, therefore, deductible in full under the provisions of the Act of October 3, 1913. This settles the question of interest for the years 1913, 1914, and 1915 in taxpayer's favor.

The provisions of the Revenue Act of 1916, however, are much stricter, and the benefits of this proviso are confined to interest paid on indebtedness wholly secured by collateral the subject of sale or hypothecation in the ordinary business of the corporation as a dealer only in the property constituting the collateral. This company is not only a dealer but a manufacturer and is not primarily a dealer in securities but only incidentally a dealer in securities and primarily a dealer and manufacturer in certain merchandise. It is not, there-

fore, entitled to the deduction of interest under this proviso in 1916, except as to interest paid on indebtedness, if any, secured by the hypothecation of merchandise or warehouse receipts therefor. This view is supported by Law Opinion 621 (revoked on other grounds by Law Opinion 634).

NOTE: This opinion has been superseded by L. O. 1035, revised; ruling 40–20–1222.

SECTION 214(a) 7.—DEDUCTIONS ALLOWED: BAD DEBTS.

SECTION 214(a) 7, ARTICLE 151: Bad debts.

(See 8–20–753; sec. 214(a) 2, art. 121.) Payment under guaranty of interest of an insolvent principal.

SECTION 214(a) 7, ARTICLE 151: Bad debts. 23–20–986
O. D. 535

Bank deposits in Russian banks can not be considered as worthless for the purpose of claiming a deductible loss in a return for the taxable year 1919. The Bureau is informed that Russian rubles in the form of bank deposits were sold during the latter months of 1919, which would indicate that they were not at that time worthless.

SECTION 214(a) 7, ARTICLE 151: Bad debts. 25–20–1017
(Also Section 214(a) 4, 5, 6, Article 141.) O. D. 556
(Also Section 219, Article 343.)

A decedent was coindorser on the note of a corporation which was in process of liquidation at the time of his death. Decedent's share of the liability was determined at the end of the calendar year 1918 and paid by the administrator of his estate in the early part of 1919.

Inasmuch as the exact amount of decedent's liability as coindorser was not known at the time of his death, the amount paid by the administrator is not deductible in the 1918 return for the decedent, but is deductible in the return by the administrator for the taxable year in which it was paid and charged off on his books, provided that all the circumstances indicated that the debt was worthless and uncollectible, and that legal action to enforce payment would in all probability not have resulted in the satisfaction of execution on a judgment.

Decedent at the time of his death was also indorser on the paper of another corporation to the amount of $40x$ dollars. The paper was past due at the time it was paid off by the administrator. The claim of the bank against the corporation, subrogated to the administrator was appraised as of date of decedent's death at $15x$ dollars, which appraisement has been adopted by the administrator as correct.

Held, that the difference between the appraised value of the claim against the company and the amount paid by the administrator in taking up the paper is not deductible as a loss for the reason that the

transaction is not a closed and completed one. So long as the claim against the company is not disposed of by the administrator, the exact amount of the loss, if any, can not be definitely determined, and, therefore, could not be claimed as a deduction.

SECTION 214(a) 7, ARTICLE 152: Examples of bad debts. 9-20-772 A. R. R. 30

A owned 51 per cent of the stock of the M Company, and from time to time advanced to the company cash to the amount of $3x$ dollars, which was evidenced in part by the company's notes. In 1915, A, upon examination of the company's affairs, learned that it was insolvent. Later he entered into a written contract by which he agreed to take over the free assets of the company not mortgaged to secure its bonded indebtedness and to assume the liabilities of the company other than the bonded indebtedness. The book value of the assets at that time was x dollars. A, however, did not charge off in his 1915 return any amount as a loss, on the ground that his loss was not determinable at that time, or until he had disposed of the assets received by him. These assets were disposed of in 1916 and apparently were sold for sufficient to pay off all outstanding creditors and to reduce A's net loss to $2x$ dollars.

The amount claimed by A as a deduction is, and must be, claimed as a bad debt. This debt was wiped out in 1915, when A canceled it and assumed further liabilities, in consideration of the transfer to him of the free assets of the company, and the measure of the loss on account of bad debt is the difference between the liabilities assumed, including the debt to himself and the value at the time of the assets received. Even if it were held that the loss was a business loss, instead of a bad debt, the result would be the same, as the loss would have to be regarded as occurring in 1915, as it has been uniformly held by the Bureau that where assets were exchanged for other assets the profit or loss in the exchange is determined by the value of the assets received at the time, and not by the amount subsequently obtained for such assets upon sale thereof.

The Committee is, therefore, of the opinion that A should be permitted to reopen his books and charge off the loss in 1915, and to file an amended return for 1915, taking a deduction for bad debts in 1915; and to make a claim for credit of the amount of tax refundable to him on account of overpayment in 1915.

SECTION 214(a) 8.—DEDUCTIONS ALLOWED. DEPRECIATION.

SECTION 214(a) 8, ARTICLE 161: Depreciation. 4-20-704 O. D. 381

No amount may be charged off in any year in anticipation of obsolescence of a building which *may* become obsolete five or ten years later. However, a certain amount of obsolescence may be claimed from the time that it becomes certain that at a definite future date the building will be obsolete. The figure representing

obsolescence should be, approximately, the difference between the fair market value of the building as of March 1, 1913, or its cost if acquired after that date, less depreciation, and the estimated salvage value. This obsolescence should be spread over the period from the time such obsolescence becomes certain until the building becomes obsolete and should be claimed in the returns filed for those years. For instance, the fair market value of a building March 1, 1913, was $30,000. Its depreciated value December 31, 1918, was represented by $18,000, and its estimated salvage value will be $5,000 in 1920. At that time (December 31, 1918) it was definitely determined and certain that in 1920 the building would have to be torn down and rebuilt, due to its inadequacy to meet the growing needs of the industry it housed. The difference between the depreciated value December 31, 1918, namely, $18,000, and its estimated salvage value of $5,000 represents obsolescence. This amount of $13,000 should be spread over the years covering the period 1919 and 1920, and deductions claimed accordingly on the returns filed for those years. In cases where obsolescence is claimed it must be supported by facts which will enable this office to determine whether such claim is proper and allowable.

SECTION 214(a) 8, ARTICLE 161: Depreciation. 9–20–773
A. R. R. 27

Held, that 3 per cent is a reasonable allowance for depreciation of bulk freight steamships on the Great Lakes and conditions stated under which additional allowance for obsolescence may be claimed.

The Committee has had under consideration the appeal of representatives of various steamship companies, members of the Lake Carriers Association engaged in the bulk transportation of ore, grain, coal, and stone upon the Great Lakes, from a decision of the Income Tax Unit fixing 2 per cent as the rate of depreciation allowable upon steamships engaged in this traffic. The decision in question was based upon an informal memorandum sent to the Unit upon a specific case.

It is understood that the tax reviewers prior to the establishment of the Advisory Tax Board heard considerable evidence presented in this case wherein it was endeavored to secure recognition of a rate of depreciation which would result in additions to the invested capital of the various companies involved. The application of the rate of 2 per cent recommended in this particular case to all other steamship interests upon the Great Lakes resulted in the instant appeal.

In view of the importance of the question the Committee granted a hearing to representatives of the companies involved at which were present steamship owners, underwriters, shipbuilders, and dock owners, and the matter was gone into exhaustively. The testimony then presented was practically uniform in fixing a maximum life of the vessels engaged in this traffic at not exceeding 35 years, the majority opinion being somewhat under this figure. The question is complicated by the fact that there is no adequate history available indicating exact life for the reason that changes in size of locks, in depth of channels, and in loading and unloading machinery have from time to time rendered the older type of vessels obsolete and

necessitated their rebuilding in order to meet changed conditions with the result as stated that no instance can be pointed out of a steel vessel which has lived out the normal life and been abandoned as useless.

In addition to the evidence presented by these gentlemen, the Committee had a conference with the Chief of the Federal Steamboat Inspection Service and members of his staff stationed on the Great Lakes, who are entirely familiar with conditions and whose testimony would be unbiased by any possible self-interest. These gentlemen concurred in the view that 33 years would probably be a maximum life of such a vessel without rebuilding.

The Committee accordingly recommends the establishment of a rate of depreciation of 3 per cent upon the vessels engaged in the bulk freight traffic. It must be recognized and remembered that this rule does not necessarily apply to steamers engaged in other lines of traffic for the reason that there are distinct differences in the method of construction and the matter of operation of package freighters and passenger steamers and the bulk freighters under consideration.

It was also urged during the hearing that because of the history of lake transportation and the evidence that practically in cycles of 10 years a complete revolution in types of vessels utilized for this traffic has been brought about, that additional allowance should be recognized in 1918 and subsequent years on account of presumed obsolescence.

The extreme that was presented was to the effect that since history had shown this, it might be presumed that even the latest type of development would be superseded within another 10 years by a different type and consequently obsolescence starts practically with the launching of the vessel. The Committee is not willing to concede this. It is manifest that there must be some point at which development will reach its maximum and the natural presumption is that the latest development is the final one. Final development is measured by depth of channels, length of locks, and capacity of loading and unloading machinery as well as by limitations upon the size and carrying capacity of vessels which are structurally safe. The Committee is therefore of the opinion that obsolescence should be limited to those cases where it can be shown that a type of vessel has been developed so much more economical than existing types, that no other than the new type will be built in future, and that a sufficient number of the new type to meet traffic requirements will in all reasonable probability be built within a certain definite period, thereby forcing the older type out of useful existence.

Where in any case this condition can be shown to exist and where moreover it can be definitely determined that the established rate of depreciation will not be sufficient to return all of the capital invested as at the date of acquisition or March 1, 1913, whichever was later, by the time the vessel will be rendered useless, an addition to the regular rate to cover this obsolescence may properly be allowed, thus permitting the spread of the foreseen loss over the period from the present time until the loss occurs instead of requiring the entire amount of such loss to be deducted in the year in which the vessel is finally scrapped or salvaged. The amount of this allowance, however, must be determined upon the basis of the facts in each particular case; that

is, the type of the vessel in question, the fitness for possible use in other lines of transportation, and the date when it can be definitely foreseen that it will be no longer commercially useful in this particular line of traffic.

SECTION 214(a) 8, ARTICLE 161: Depreciation.

(See 15–20–855; sec. 331, art. 941.) Basis for depreciation deductions on account of assets acquired in reorganization.

SECTION 214(a) 8, ARTICLE 163: Depreciation of intangible property.

(See 10–20–777; sec. 202, art. 1561.) Methods of determining value of intangible assets as at March 1, 1913.

SECTION 214(a) 8, ARTICLE 163: Depreciation of intangible property. 17–20–884 O. D. 472

Obsolescence is not ordinarily applicable in the case of intangibles but will be allowed in exceptional cases, as in the case of the discontinuance of a going business because of the exhaustion of its source of supply, where the cost of the good will, or its value as of March 1, 1913, if acquired prior to that date, can be definitely shown and the period of its obsolescence determined with reasonable accuracy.

To sustain a claim for deduction for obsolescence of good will, it must be shown that the good will will be of no value at the close of an approximately definite period, and that the taxpayer will be forced to discontinue the business and be unable to continue in any similar business.

An allowance for obsolescence of good will will be made only in connection with such good will as is assignable, as distinguished from good will attaching to individuals owning or conducting a business, or to the premises at which it is or was conducted; and no allowance for obsolescence will be granted in any case where, in connection with the operation of the business, the good will will be valuable in another business after the termination of the business in which the taxpayer is engaged.

A corporation engaged in the business of sampling ores is entitled to a deduction for obsolescence not only of its plant and equipment but for value of good will existing and having a definitely established value as of March 1, 1913, or acquired thereafter by capital outlay, if it can be shown that the plant and equipment will be useless and the good will of no value at the close of an approximately definite period by reason of exhaustion of the ores on which its business depends.

SECTION 214(a) 8, ARTICLE 165: Method of computing depreciation allowance. 16–20–862 A. R. R. 45

When delicate machinery designed for the manufacture of a certain product is used in manufacturing a product of much coarser mate-

rials for which use it is not fitted, and is operated at a heavy overload of its normal capacity, the owner is entitled to deduct from gross income an amount representing extraordinary depreciation.

SECTION 214(a) 8, ARTICLE 167: Depreciation of patent or copyright. 10-20-779 A. R. M. 35

A invented certain apparatus and secured United States patents thereon. The patents were assigned to a foreign corporation under an agreement by which he retained 40 per cent interest in profits therefrom. Legal title to the patents passed to the company subject to the agreement mentioned. A's interest was recognized by the company and by the United States licensees under the patents. The Committee is of the opinion that the agreement should be recognized as giving A a depreciable interest in the patents.

The value of each patent as at March 1, 1913, should be segregated and the depreciation allowable thereon determined on the basis of its own life instead of using as a basis the average life of all the patents and the value of all the patents in bulk. Of the total depreciation allowable for any year, 60 per cent is deductible in the return of the company and 40 per cent in A's return.

SECTION 214(a) 8, ARTICLE 167: Depreciation of patent or copyright.

(See 20-20-934; sec. 214(a) 1, art. 101.) Deduction of amounts expended in litigation defending title to a patent.

SECTION 214(a) 8, ARTICLE 170: Closing depreciation account. 19-20-919 A. R. R. 93
(Also Section 214(a) 4, 5, 6, Article 143.)

Recommended that the loss claimed by the M Company in its 1917 return be allowed in full.

The Committee has had under consideration the appeal of the M Company, a corporation engaged in distilling, from a ruling of the Income Tax Unit disallowing a loss claimed in the return of the company for 1917.

This corporation was compelled by operation of law to cease manufacturing operations in 1917. Under the ruling of the office, distilling corporations may, in the case of distilling properties which have not been sold and the value of which has been reduced by reason of the compulsory abandonment of their operations, take a reasonable allowance for exhaustion or obsolescence upon a proper showing of facts. The M Company, under this ruling, claimed a loss which after having been deducted left an apparent remaining value of $150x$ dollars. In the preliminary audit of the return the loss claimed was reduced to $22x$ dollars based on 5 per cent of the reported cost. The taxpayer protested and submitted his books, after a careful consideration of which the Unit determined that not suf-

ficient depreciation had been charged on certain items of the property in previous years and from the books determined a depreciated value as of December 31, 1917, of 275x dollars. Holding the company to the estimated residual value of 150x dollars the Unit finds that the loss was 125x dollars, leaving a part of the original claim to be disallowed.

The plant was actually sold in 1918 for 25x dollars and the sole question under consideration at the present time is whether the company should be held to its estimate of 150x dollars as the value of the plant at the close of 1917. In the opinion of the Committee the actual sale in 1918 for 25x dollars conclusively establishes that the estimate of 150x dollars was too high and it recommends therefore that the loss as claimed be allowed in full.

This will have the effect of reducing the amount of loss which may be claimed in the 1918 return.

SECTION 214(a) 9.—DEDUCTIONS ALLOWED: AMORTIZATION.

SECTION 214(a) 9, ARTICLE 184: Cost which may be amortized.

(See 3–20–692, sec. 250, art. 1005.) Five per cent penalty and interest, as applied in cases where excessive amortization has been deducted in returns.

SECTION 214(a) 10.—DEDUCTIONS ALLOWED: DEPLETION.

SECTION 214(a) 10, ARTICLE 201: Depletion of mines, oil and gas wells.

(See 15–20–855; sec. 331, art. 941.) Basis for depletion deductions on account of assets acquired in reorganization.

SECTION 214(a) 10, ARTICLE 201: Depletion of mines, oil and gas wells. 18–20–900 S. 1365

ACT OF OCTOBER 3, 1913, AND REVENUE ACT OF 1916.

A lease to mine coal in the State of Pennsylvania contained, among other provisions, the following:

(1) To demise, lease, and mine let to the lessee all coal in, upon, and under certain lands owned by the lessor.

(2) The lessee was given the right to mine, remove, and dispose of the coal.

(3) The lessor retained the privilege at any time after the expiration of the first 10 years of the lease to sell the leased property upon giving 6 months' notice to the lessee and affording the lessee an opportunity to purchase the property.

(4) The lease was not to be assigned by the lessee without the consent of the lessor.

(5) The lessors retained absolutely the right to sell the property subject to the terms of lease.

Upon termination of this lease, a new lease agreement was made containing, among other provisions, the following:

(1) Term of lease, 10 years.

(2) Lessee to mine and remove as much coal as possible by reasonably diligent mining operations.

(3) The lessee agreed not to assign the lease without consent of the lessor, but had the right to sublet portions of the surface without consent of the lessor.

(4) Upon failure of the lessee to comply with all conditions of the agreement, the lessor had the right to declare a forfeiture of the unexpired portion of the lease.

Held, that leases to mine coal in the State of Pennsylvania of the character described do not constitute sales of the coal in place and the royalties received thereunder are income to the lessors.

"Gross value at the mine," as used in paragraph G (b) of the Act of October 3, 1913, means, in the case of a coal mine, the market value of the prepared coal at the mine, where such value is established by actual sales at the mine; and where the market value is established at some place other than the mine, the gross value at the mine means the price for which the coal is sold less transportation charges.

The annual deduction allowable to the lessor for depletion in this case, under the Revenue Act of 1916, is to be determined by dividing the fair market value of the entire body of coal in place on March 1, 1913, by the estimated content of the mine in tons and multiplying the result so obtained by the number of tons of coal taken out each year. (See article 172, Regulations 33, revised.) In the absence of evidence showing a change in value between March 1, 1913, and May 1, 1914, the price at which the property was offered for sale on the latter date may be accepted as its fair market value on March 1, 1913.

SECTION 214(a) 10, ARTICLE 202: Capital recoverable through depletion allowance in the case of owner. (Also Section 212, Article 23.)

2–20–674
A. R. M. 17

A lessor of mining property who waives his rights of royalties for several years by reason of the fact that the mine was operated at a loss and receives all of the royalties in the year 1917, may, if he has submitted returns for these years on a cash receipts and payments basis, deduct from the income received in 1917 such depletion allowance as appertains to that income.

The question raised is whether a lessor of mining property who receives in a given year royalties that accrued over several years may, if he reports income on a cash receipts and payments basis, deduct from the royalties received such part of the depletion allowance as appertains to those royalties.

A leased property to a coal mining company. Although coal was taken from the mine for several years, the company was sustaining losses. A agreed to waive his rights to the royalties until such time as the company was able to pay them. During the year 1917

A received royalties presumably including accruals of preceding years, in whole or in part.

In each year profit or income from the property accrued as to the taxpayer. If his returns for these years had been on an accrual basis, he would have been obligated to include the amount of this income, less the depletion accruing in each year, in his return for each year. Assuming he reported on a cash receipts and payments basis, as he did in the year 1917, for these several years, he was entitled, under the Acts prevailing, to include only income actually received. Since the income thus reported included what would have been accrued income over a period of years, he is entitled to such deductions for depletion as accrued during those years.

Accordingly, the deductions of depletion are allowable, and if the amount of royalty received does not represent the full extent of the accrual, it is presumed that it represents the earliest accruals and is subject to such offsets for depletion as may be allocated to the earliest accruals.

SECTION 214(a) 10, ARTICLE 203: Capital recoverable through depletion allowance in the case of lessee. (Also Section 234, Article 561.)

20–20–938
O. 1033

INCOME TAX: SECTION 12(a), REVENUE ACT OF 1916.

Where a corporation, organized for the purpose, takes over a mining lease, issuing its entire capital stock to the individual owners of the lease in the proportion of their respective interests therein the "capital actually invested in the lease," for the purpose of the deductions allowed by section 12(a) of the Revenue Act of 1916, is the fair market value of the stock so issued.

The question is raised as to what constitutes the "capital actually invested in the lease" within the meaning of article 171 of Regulations 33, revised, where a corporation, organized for the purpose, takes over a mining lease, issuing its entire stock to the individual owners of such lease in the proportion of their respective interests.

Section 12(a) of the Revenue Act of 1916, provides that:

In the case of a corporation, * * * 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.

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 to which the corporation has not taken or is not taking title, or in which it has no equity.

Second. * * * (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made, * * *: *Provided*, That when the allowance authorized in * * * (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made; * * *

The inquiry in this case is made in connection with the following statement of facts: A mining lease was acquired without bonus in 1915 by individuals who drilled ground at a cost of x dollars locating an ore body. Under the Revenue Act of 1918 discovery to the

value of $14x$ dollars could be substantiated as of June, 1916. Subsequent to that date a corporation was organized by the same individuals and the lease was assigned to it in consideration of the issue of its entire capital stock to such individuals in the proportion of their respective interests.

The question to be decided may be specifically stated in the following form: Is this corporation entitled to a deduction in 1916 and 1917 based (a) on the actual value of the lease on the date of acquisition by it, i. e., on $14x$ dollars or (b) only on the cost of the lease to the individual owners to the date of the transfer, i. e., on x dollars, plus proper capital additions recoverable through depletion in either case?

The lessee of a mine is not entitled to depletion under the Revenue Act of 1916. (*Weiss* v. *Mohawk Mining Co.*, decided by the United States Circuit Court of Appeals, Sixth Circuit, Mar. 2, 1920.)

Article 171 of Regulations 33, revised, provides that:

> The deduction in the case of a lessee [of a mine] will be limited to an amount equal to the *capital actually invested in the lease*, without regard to value as of March 1, 1913, or any other date.

In accordance with this regulation so long as the mining lease in question remained the property of the individual owners they could only have deducted a total of x dollars. Is then the corporation organized by them and taking over the lease in exchange for its entire capital stock entitled to a greater deduction?

That the former owners now constitute the corporation is not to be denied. "But, looking through the form, we can not disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none. * * * We must treat the corporation as a substantial entity separate from the stockholder. * * *" (*Eisner* v. *Macomber*, decided by Supreme Court of United States, March 8, 1920.) So treating the corporation and its stockholders, the transaction in question constituted a sale by which the corporation acquired property worth $14x$ dollars and the former owners, since the Act of 1916 makes no provision for depletion in the case of the value of mining property acquired through discovery, received jointly income in the amount of the difference between the fair market value of the stock issued to them and the cost of the lease to them. If the owners of the lease had organized a corporation jointly subscribing for its stock $14x$ dollars in cash and the corporation had then purchased from them the very lease here in question there would be no question that the cost of the lease to the corporation would have been $14x$ dollars. The result is not changed by the fact that they adopted the more direct method. The cost of the lease to the corporation was the value of the stock issued in exchange for it.

It is therefore held, that where a corporation, organized for the purpose, takes over a mining lease, issuing its entire capital stock to the individual owners of the lease in the proportion of their respective interests therein the "capital actually invested in the lease," for the purpose of the deductions allowed by section 12(a) of the Revenue Act of 1916 is the fair market value of the stock so issued.

SECTION 214(a) 10, ARTICLE 220(a): Discovery—Proven tract or lease—Property—Disproportionate value. 22-20-970 O. D. 527

1. In determining the market value, for depletion purposes, of "property" upon which oil or gas wells have been discovered since March 1, 1913, the "private bounding lines," mentioned in article 220(a) 3, Regulations 45, refer to the *exterior limit of a continuous tract held under lease or leases or in fee by the taxpayer.* To illustrate:

The X Company has leases upon the S. E. quarter of the N. W. quarter of section 10. The X Company holds this land under five separate leases from different fee owners. A well is brought in upon the land, conceded to be a discovery well, subsequent to the acquiring of the leases by the company, and so located as to include the entire 40 acres of X Company in the proven area. The property to be valued is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content of this particular sand, zone, or reservoir, in which the discovery was made, to the limits of the entire 40 acres held by X Company. If the "private bounding lines" in article 220(a) 3 were interpreted to mean the boundaries of each lease, it would enable the X Company to value one well subsequently brought in upon each of the five leases, and such a result would be contrary to the purpose of article 220.

2. Wells drilled upon a proven tract which has already been valued under the provisions of section 214(a) 10 of the Revenue Act of 1918, have no significance upon the value previously given the "property." But wells brought in upon a proven area still further extend the proven area. To illustrate:

The A Company owns an acreage of land upon which a discovery well is brought in, all of the proven area being included in the acreage. The A Company, for the purpose of ascertaining allowable deductions for depletion, determines the fair market value of the "well," i. e. (1) the drill hole, (2) the surface necessary for the drilling and operation of the well, and (3) the oil or gas content of the particular sand, zone, or reservoir, in which the discovery was made by the drilling, and from which the production is drawn. The great increase in value, of course, is from item (3), the oil or gas content of the sand, zone, or reservoir. If the A Company were allowed to value other wells brought in upon this proven area, it would in fact be valuing the same oil and gas content of the sand, zone, or reservoir, which had previously been valued and upon which depletion was being taken. Such a result would be distinctly contrary to the theory of income taxation and the purpose of article 220. However, the bringing in of other wells upon this proven area, still further extends the proven area to the extent provided in article 220, and wells brought in upon an area so proven can not be revalued unless the land was acquired before proven.

3. If a well should be drilled in the corner of a quarter section of land owned by the taxpayer, to be able to value the portion of the quarter section not proven by the well, it would be necessary for other wells to be brought in upon the area not proven by the first well.

SECTION 214(a) 11.—DEDUCTIONS ALLOWED: CHARITABLE CONTRIBUTIONS.

SECTION 214(a) 11, ARTICLE 251: Charitable contributions. 5-20-716 O. D. 389
(Also Section 231, Article 517.)

The Community Service (Inc.) is a charitable and educational corporation exempt from taxation under the provisions of section 231(6) of the Revenue Act of 1918 and, therefore, contributions made to it by individuals are deductible to the extent provided in section 214(a) 11.

SECTION 214(a) 11, ARTICLE 251: Charitable contributions. 7-20-740 O. 979

INCOME TAX: SECTION 214(a) 11, REVENUE ACT OF 1918.

Where a gift is other than money, the basis of the calculation of the amount of the gift for the purpose of the deduction allowed under section 214(a) 11 shall be the cost of the property or its fair market value as of March 1, 1913, after deducting from such cost or value the amount, if any, which has been or should have been set aside and deducted in the current year and previous years from gross income on account of depreciation and which has not been paid out in making good the depreciation sustained.

The question is raised as to the amount of deduction allowable in the case of a gift to any of the several corporations enumerated in section 214(a) 11 of the Revenue Act of 1918.

The section in question provides:

(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, or to any special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act, to an amount not in excess of 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. * * *

Article 251 of Regulations 45 provides in part that:

Where the gift is other than money the basis for calculation of the amount of the gift shall be the fair market value of the property at the time given.

The deductions allowed under this paragraph are deductions in computing net income and are included with other deductions of which those allowed for losses are most similar. This paragraph is therefore to be considered with reference to the provisions of the law relating to the computing of net income and to losses.

Appreciation in the value of property is not considered income to the taxpayer prior to its realization through the conversion of the property (article 23, Regulations 45). And, on the other hand, losses are only deductible when they have been realized—that is to say, when evidenced by closed and completed transactions. A gift of property by a taxpayer is not a realization of gain or of loss.

Where a loss is claimed through the destruction of property by fire, flood, or other casualty, the amount deductible is the difference

between the cost of the property or its fair market value as of March 1, 1913, and the salvage value thereof after deducting from the cost or value as of March 1, 1913, the amount, if any, which has been or should have been set aside and deducted from gross income on account of depreciation, and which has not been paid out in making good the depreciation sustained (article 141, Regulations 45). The same principle is applicable to deductions on account of charitable contributions where the subject of the gift is property rather than money.

It is therefore held that where a gift is other than money, the basis of the calculation of the amount of the gift for the purpose of the deduction allowed under section 214(a) 11 should be the cost of the property or its fair market value as of March 1, 1913, after deducting from such cost or value the amount, if any, which has been or should have been set aside and deducted in the current year and previous years from gross income on account of depreciation and which has not been paid out in making good the depreciation sustained.

SECTION 214(a) 11, ARTICLE 251: Charitable contributions. 8-20-755
(Also section 231, Article 517.) S. 1246

INCOME TAX: SECTION 214(a) 11, REVENUE ACT OF 1918.

Contributions or gifts made to a corporation organized and operated exclusively for the purpose of erecting and maintaining monuments or other like memorials are not allowable deductions in computing net income of individuals contributing thereto, even though no part of the net earnings of such corporation inures to the benefit of any private stockholder or individual, such corporations not being charitable or educational institutions within the meaning of the Revenue Act of 1918. The status of corporations whose purposes involve a positive dissemination of knowledge should be determined on proper facts submitted in each case.

Opinion is submitted generally on the question as to whether or not contributions made to a corporation organized and operated exclusively for the purpose of erecting or maintaining monuments or other like memorials, no part of the earnings of which inures to the benefit of any private stockholder or individual, are allowable deductions in computing net income of the respective individuals contributing thereto as being gifts to a charitable or educational institution. Section 214 of the Revenue Act of 1918 reads:

(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 * * * no part of the net earnings of which inures to the benefit of any private stockholder or individual.

The question resolves itself into an inquiry as to whether or not such a corporation is an educational or charitable institution within the meaning of the Act.

I. The term "charitable" has been given a very broad meaning by the courts, but it is noticeable that the decisions applying the broadest meaning are in cases involving "charitable uses," that is, where there is a trust for a charitable purpose. It is, of course, expedient

to uphold such trusts where a construction of the law will possibly permit it. But the application of the term to cases involving the taxation of property belonging to institutions such as those herein discussed has not often been before the courts. Thus, in a note in 26 L. R. A. (N. S.) 707, written in 1910, the statement is made:

> There appears to be no other case involving the taxation of property belonging to a patriotic society such as the D. A. R., but a few cases have held that armories used by military organizations or branches of the National Guard are exempt.

The case referred to in the above L. R. A. note is *Mollie Varnum Chapter, D. A. R.* v. *City of Lowell* (204 Mass., 487; 90 N. E., 893), in which it is held:

> Real estate owned and occupied by a chapter of the D. A. R. chartered "for the purpose of perpetuating the memory of the men and women who achieved American independence, of acquiring and protecting historic spots, encouraging historical research and the publication of its results, preserving documents and relics and individual records of Revolutionary soldiers and patriots, and promoting the celebration of patriotic anniversaries, or cherishing, maintaining, and extending the institution of Amercan freedom, and fosterng true patriotism and love of country," and which has, in addition to its chartered purposes, aided in the relief of the destitute, made gifts to public schools, assisted in the establishment of a public library and in the maintenance of a boys' club for industrial work, and a sewing class for girls—is within a statute exempting from taxation the property of "literary, benevolent, charitable, and scientific institutions."
>
> * * * The diffusion of knowledge, the relief of the poor, the fostering of love of country and of respect for our civil institutions—all tend to raise the standard and improve the quality of citizenship, and not only relieve the burdens of government, but advance the public good. The gratuitous benefit thus conferred serves only charitable purposes and entitles the plaintiff to the statutory exemption.

Serious doubt is entertained whether this decision is correct; but, even if it is accepted as correct, it is not controlling here. The Massachusetts statute under which it was decided evidenced a much broader exempting intention than the one here to be considered; further, the court emphasized also the fact that the D. A. R. chapter had among its objects the relief of the poor. That feature is wholly absent here; there is no charitable element in the present case in the generally accepted meaning of the word "charitable."

II. Is such a corporation to be considered an educational institution within the meaning of the Revenue Acts?

Article 517(1), Regulations 45, provides:

> Educational corporations may include an association whose sole purpose is the instruction of the public. This is true of an association to promote acquaintance with the Spanish language and literature, although it has incidental amusement features; of an association to increase knowledge of the civilization of another country; and of a Chautauqua association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community and whose amusement features are incidental to this purpose.

Cases under State taxing laws are found, such as *Mergentine's Estate* (129 App. Div. 376, N. Y.) and *Town of Essex* v. *Brooks* (164 Mass., 79), in which museums, libraries, art galleries, etc., have been held to be educational institutions. But no case is found holding a monument or other similar memorial to have any educational qualities within the meaning of taxing acts. And it is not believed that Congress intended to extend the meaning of the word to cases where

the instructive value of the object is as doubtful as in the cases here under discussion.

It is extremely doubtful if most such institutions, erecting and maintaining monuments and memorials, fulfill the requirement of the statute that they be organized and operated exclusively for religious, charitable, scientific, or educational purposes. The purpose of a monument or other like memorial will no doubt in most cases include a purpose to adorn or beautify a particular location, and in some cases to perpetuate the memory of an individual from private motives.

It is recognized, however, that cases may arise in which the purpose of the memorial is to include the giving of educational lectures or some other form of positive dissemination of knowledge, and institutions organized and operated to these ends might well be classed as educational. It is necessary then that each doubtful case be decided on its own merits. Therefore, the information required in article 511, Regulations 45, should be called for in all such doubtful cases, not only to determine the institution's right to exemption, but also the individual contributor's right to make deduction of his gift.

The foregoing deals entirely with the right of an individual making the gift. The rights of partnerships, estates and trusts, and corporations to deductions on account of such gifts are discussed in sections 218 and 219 of the Revenue Act of 1918 and articles 561 and 562 of Regulations 45.

It is therefore held that contributions or gifts made to a corporation organized and operated exclusively for the purpose of erecting and maintaining monuments or other like memorials are not allowable deductions in computing net income of individuals contributing thereto, even though no part of the net earnings of such corporations inures to the benefit of any private stockholder or individual, such corporations not being charitable or educational institutions within the meaning of the Revenue Act of 1918. The status of such corporations as have additional purposes involving a positive dissemination of knowledge should be determined on proper facts submitted in each case.

SECTION 214(a) 11, ARTICLE 251: Charitable contributions.

(See 14-20-834; sec. 231, art. 519.) Contributions to the American Legion.

SECTION 214(a) 11, ARTICLE 251: Charitable contributions. 15-20-856
T. D. 2998

Article 251 of Regulations 45 is hereby amended to read as follows:

ART. 251. *Charitable contributions.*—Contributions or gifts within the taxable year are deductible to an aggregate amount not in excess of 15 per cent of the taxpayer's net income, including such payments, if made (a) to corporations or associations of the kind exempted from tax by subdivision (6) of section 231 of the statute or (b) to the special fund for vocational rehabilitation under the Vocational Rehabilitation Act of June 27, 1918. For a discussion of what corporations and associations are included within (a) see article 517. A gift to a

common agency (as a war chest) for several such corporations or associations is treated like a gift direct to them. In connection with claims for this deduction there shall be stated on returns of income the name and address of each organization to which a gift was made, and the approximate date and the amount of the gift in each case. Where the gift is other than money the basis for calculation of the amount of the gift shall be the cost of the property, if acquired after February 28, 1913, or its fair market value as of March 1, 1913, if acquired prior thereto, after deducting from such cost or value the amount, if any, which has been or which should have been set aside and deducted in the current year and previous years from gross income on account of depreciation, and which has not been paid out in making good the depreciation sustained. A gift of real estate to a city to be maintained perpetually as a public park is not an allowable deduction. The proportionate share of contributions made by a partnership to corporations or associations of the kind included in (a) above and to the special fund for vocational rehabilitation specified in (b) may be claimed as deductions in the personal returns of the partners to an amount which, added to the amount of such contributions made by the partner individually, is not in excess of 15 per cent of the partner's net income computed without the benefit of the deduction for such contributions. However, the contributions made by the partnership shall not be deducted from its gross income in ascertaining the amount of its net income to be reported on Form 1065, revised. See article 321. This article does not apply to gifts by estates and trusts or corporations. See section 219 of the statute and articles 561 and 562.

This decision supersedes Treasury Decisions 2966 and 2977.

SECTION 214(a) 11, ARTICLE 251: Charitable contributions. 16–20–863 O. D. 465

A contribution of money toward the cost of an article presented by the contributors to a corporation organized exclusively for educational purposes is deductible from the gross income of the donors within the 15 per cent limitation provided by section 214(a) 11 of the Revenue Act of 1918. The character of the organization receiving the gift rather than the purpose to which the gift is put is the test of deductibility.

SECTION 214(a) 11, ARTICLE 251: Charitable contributions. 22–20–971 S. 1362
(Also Section 231, Article 517.)

INCOME TAX: SECTION 214(a) 11, REVENUE ACT OF 1918.

An association engaged in disseminating propaganda to encourage the passage of labor legislation is not an educational association within the meaning of section 214(a) 11 and therefore contributions to it may not be deducted from gross income when computing net income subject to taxation under the Revenue Act of 1918.

Opinion has been requested whether the M Association is an educational organization within the meaning of section 214(a) 11, Revenue Act of 1918, and whether contributions made to it by individual taxpayers may be deducted from gross income when computing net income subject to taxation under the Act. The objects of the M Association as set forth in its constitution are in part:

To promote uniformity of labor legislation in the United States and to encourage the study of labor conditions in the United States with a view to promoting desirable labor legislation.

From the objects and from the report of the work of the association, in 1919, the great portion of the work consists in gathering data with reference to labor conditions, and disseminating this data to the public with the idea of educating the public and encouraging the study of labor conditions, for the ultimate purpose, however, *of effectuating beneficial labor legislation.*

Section 214(a) 11 of the Revenue Act of 1918 provides in part as follows:

> That in computing net income there shall be allowed as deductions: * * * Contributions or gifts made within the taxable year to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, * * *.

Article 517, Regulations 45, provides in part as follows:

> * * * Educational corporations may include an association whose sole purpose is the instruction of the public. This is true of an association to promote acquaintance with the Spanish language and literature, although it has incidental amusement features; of an association to increase knowledge of the civilization of another country; and of a Chautauqua association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community and whose amusement features are incidental to this purpose. But associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute.

The attorneys for the association contend that the association is educational within the meaning of the Act and that part of article 517 set forth above. They contend that the prime object of the association is to instruct the public as to the needs of workers in order that legislation benefiting them may be secured. Prior to the issuance of Regulations 45, this office ruled as follows:

> An association organized and operated solely in order to educate the public sentiment of a State in favor of the prohibition of the sale of intoxicating liquors, and devoting all of its funds to this purpose is organized and operated exclusively for an "educational purpose." S. 200, May 16, 1918.
>
> A corporation organized and operated in order to educate public sentiment in favor of the doctrine of protection is "educational" in character and exempt from income tax; and donations to its funds may be deducted in computing the net income of the donor. S. 455, August 28, 1918.

This opinion also contained the sentence—

> The work of the club is propagandist, but none the less educational.

Article 517, Regulations 45, approved April 17, 1919, contains the sentence—

> But associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute.

As opposed to the rule announced in the foregoing quotation from the regulations the case of In re *Field*, 71 Misc. (N. Y.) 396, may be cited. In that case it was decided that the Women's Christian Temperance Union was an educational institution within the meaning of section 221 of the New York Transfer Tax law, exempting from transfer tax bequests and devises to "any * * * educational * * * corporation." The statute there construed differs from section 214(a) 11 of the Revenue Act of 1918 in that it does not specify that corporations claiming the exemption must be organized and operated *exclusively* for the favored purposes. The court in its opinion lays some stress on the fact that the W. C. T. U. conducted no small amount of school and classroom work, in connection with its other functions, and it may be that the decision would have been other-

wise were the more narrow Federal Act applicable. In my opinion the decision of a State court, construing a State law differing materially from the Revenue Act of 1918, is not sufficiently compelling as an authority to force a departure from a rule steadily adhered to since its promulgation by the Bureau.

It appears that the Administrative Unit has construed the sentence, referred to in Regulations 45, as overruling S. 200 and S. 455, and has therefore denied classification as "educational" to the National Dry Federation and other abstinence societies on the ground that they were the distributors of partisan propaganda. In my opinion the construction placed upon Regulations 45 by the Administrative Unit is correct, and Solicitor's Memoranda 200 and 455 are hereby expressly declared to be overruled.

It is my further opinion that the rule announced in article 517, referred to above, is sound and should be adhered to. Education, in a broad sense and with reference to man, comprehends all that disciplines and enlightens the understanding, corrects the temper, cultivates the taste, and forms the manners and habits. Century Dictionary, page 1845. It is the process of developing and training the powers and capabilities of human individuals. *Mt. Herman Boys' School* v. *Gill* (Mass.), 13 N. E. 354, 357. The prime purpose of education is to benefit the individual. Century Dictionary, page 1845. On the other hand, the primary purpose of propaganda is much more narrow. Propaganda is that which propagates the tenets or principles of a particular doctrine by zealous dissemination. Century Dictionary, page 4774. It is a matter of common knowledge that propaganda in the popular sense is disseminated not primarily to benefit the individual at whom it is directed, but to accomplish the purpose or purposes of the person instigating it. In my opinion this is a very material difference. I believe that it was Congress' intention, when providing for the deduction of contributions to educational corporations, not to benefit and assist the aims of one class against another, not to encourage the dissemination of ideas in support of one doctrine as opposed to another, to the profit of one class and to the detriment perhaps of another, but to foster education in its true and broadest sense, thereby advancing the interest of all, over the objection of none.

The attorneys for the M Association candidly admit that the prime object of the association is to instruct the public as to the needs of workers "in order that legislation benefiting them may be secured." This instruction is carried on in various ways. A magazine is published, discussion is stimulated, memoranda are prepared and distributed, and, in short, all of the ordinary means are utilized to place before the public matter which will press labor's interests. In other words, the purpose is by propaganda to advance the interests of the workers. Although the severity of the characterization of the association as propagandist is mitigated by its praiseworthy objects, it can not, in my opinion, be denied that the classification is correct.

It is held that the M Associaton is not an educational association within the meaning of section 214(a) 11, and therefore contributions to it may not be deducted from gross income when computing net income subject to taxation under the Revenue Act of 1918.

SECTION 214(a) 12.—DEDUCTIONS ALLOWED: LOSS IN INVENTORY.

SECTION 214(a) 12, ARTICLE 261: Loss in inventory and from rebates. 26–20–1028
(Also Section 214(a) 1, Article 111.) A. R. R. 155

Held, in the appeal of the O Company, that any loss sustained by it through the return of goods in 1919 which had been sold in 1918 is a loss of the year in which the goods were returned and not of the year in which the sales were made.

The O Company is a corporation manufacturing patent flours. It appears that in 1918 it sold large quantities of these flours which during the period of the war were manufactured largely from substitutes. Upon the cessation of hostilities the Food Administration abolished the regulations covering the use of such substitutes, and as other products became available the public refused to purchase this flour. The taxpayer thereupon took back the stock which was in the hands of its jobbers. Such returns from January, 1919, to June 11, 1919, inclusive, amounted to $20x$ dollars, from which the taxpayer has deducted the resales of returned goods and the inventory on hand June 12, 1919, amounting to $7x$ dollars, leaving a balance, which it terms "net loss on 1918 sales," of $13x$ dollars, thus reducing its net profit for 1918 from $30x$ dollars to $17x$ dollars. This claim the Income Tax Unit has disallowed in an office letter under date of March 26, 1920, from which the following paragraphs are quoted:

It is noted that your claim is based upon the return during 1919 of goods sold during 1918 and which were not included in your inventory as at the close of the year 1918.

Any loss due to the sale of such goods will be reflected in your 1919 return and is not subject to adjustment under section 214(a) 12 of the Revenue Act of 1918.

You are therefore advised that your claim for abatement will be rejected.

The Committee finds no occasion for dissenting from the action of the Unit. The law is as follows:

Section 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. * * *

It does not appear from the record whether there was an actual loss sustained by this taxpayer through the resale of these goods below cost of manufacture, or whether the so-called "loss" was merely a reduction in the amount of profit that would have been made if the goods had not been taken back from the jobbing houses; but this had no material effect upon the case.

The goods were actually sold and delivered to the consignees in 1918, and were retained by them throughout that year, so that there could have been no loss in that year "resulting from any material reduction of the value of the inventory" because such goods were not included in the inventory on December 31, 1918. Neither were

any rebates made after the close of that taxable year "in pursuance of contracts entered into during such year upon sales made during such year." Whether or not the taxpayer accepted the return of such goods in 1919 appears to have been a matter entirely at its own option and if, as a matter of business prudence and expediency, it decided so to do, the resulting loss, if any, was due to its own act and by its own election in 1919, and is assuredly not such a loss as can be properly charged, under the law, against the profits of the year 1918.

Therefore, the Committee holds that the action of the Unit in denying the claim of the taxpayer as a loss in 1918 is correct and recommends that such action be sustained.

SECTION 214(a) 12, ARTICLE 262: Loss from rebates. 4–20–705 O. D. 382

Rebates made during 1919 on account of defective goods purchased in 1918 are not of the class referred to in section 214(a) 12 or section 234(a) 14 of the Revenue Act of 1918 and can not, therefore, be included in a claim for abatement or refund filed under the provision of those sections. Rebates actually paid in cash under a contract may be included in such a claim.

SECTION 214(a) 12, ARTICLE 263: Loss in inventory. 5–20–717 O. D. 390

An established loss through reduction after the close of the taxable year 1918 in the value of liquor inventoried at the close of that year and remaining unsold at the close of the taxable year 1919 constitutes an allowable deduction under Section 214(a) 12 of the Revenue Act of 1918. The lack of market for and lack of market value of the liquor must be established.

SECTION 214(a) 12, ARTICLE 263: Loss in inventory.

(See 9–20–765; sec. 203, art 1582.) Inventory value of stocks of liquor on hand December 31, 1919.

SECTION 215.—ITEMS NOT DEDUCTIBLE.

SECTION 215, ARTICLE 291: Personal and family expenses. 6–20–730 O. D. 399

A trust fund was created by a divorced husband to continue during the life of his former wife as a guaranty of payment to her of a stipulated amount in lieu of alimony, any income in excess of the stipulated amount to be paid to him and the principal to revert to him upon her death.

Held, that the principal of the trust is a part of his estate; that he is the real beneficiary of the trust; and that the entire income from the trust fund must be included in his return of income.

SECTION 215, ARTICLE 291: Personal and family expenses. 24–20–1003 O. D. 546

Amounts paid as damages for breach of promise to marry are considered personal expenses which are not deductible from the gross income of the taxpayer.

SECTION 215, ARTICLE 292: Traveling expenses. 15–20–848 O. D. 451

Where an employee is required, by the terms and conditions of a contract of employment, to travel from one country to another and no allowance is made to reimburse him for such expenditure, his traveling expenses (not including cost of meals and lodging) are an allowable deduction as a business expense, in accordance with the provisions of section 214(a) 1. Where a man makes a contract of employment with an employer in this country, and upon completion of such contract he makes a second contract with another employer in a foreign country, without allowance for travel expenses, the expenditure incurred in reaching such place of employment cannot be considered as an expense incurred in furtherance of a trade or business, but rather as an expenditure to fulfill a condition precedent to such employment in a trade or business and is therefore regarded as a personal expense and not deductible. The test is whether an expense is incurred primarily because of business as the immediate cause inducing the expenditure.

SECTION 215, ARTICLE 293: Capital expenditures. 15–20–849 O. D. 452
(Also Section 214(a) 1, Article 104.)

State bar examination fees and traveling expenses incurred and paid by a lawyer in securing admission to practice his profession are in the nature of capital expenditures and may not be deducted from gross income.

SECTION 215, ARTICLE 293: Capital expenditures. 17–20–885 O. D. 473
(Also Section 214(a) 1, Article 101.)

Seats on various exchanges were purchased by a partnership from partnership funds. Since the rules of the exchanges permit only individuals to hold seats, the seats were issued in the names of the members of the partnership. The holders of the seats buy and sell on the exchanges for themselves as well as for the account of other persons. When the seats were purchased, the amount expended was charged to "membership account" and carried as capital expenditure in the partnership books. The partnership agreement contains no provision as to the disposition of the seats upon termination of the partnership. It is stated that the partnership has no right, claim or title to the seats and that they represent nothing tangible or of any value to the partnership.

Held, that the amounts so expended by the partnership for seats on exchanges for its members are investments of capital and not deductible from gross income of the partnership as business expenses.

SECTION 215, ARTICLE 293: Capital expenditures. 19–20–920 A. R. R. 97

Held, that the action of the Unit in disallowing the amount expended for replacement of air shaft by the M Company, charged to expense in 1917, is correct.

The Committee has had under consideration the appeal of the M Company from the action of the Unit in increasing its income for 1917 by the amount of x dollars, such increase arising from the disallowance of expenditures for work, labor, machinery, and material in replacing an air shaft, such expenditures being claimed by the company as ordinary and necessary expenses of doing business while the Unit holds that the expenditures are properly capital items.

The facts in the case appear to be that in 1915 the air shaft of the company's mine caved in, causing the destruction of a fan, boiler, and drum. The company did not charge off the loss in 1915 because it had no net income during that year, but in 1917 restored the equipment and claims the cost to be merely a replacement.

In the judgment of the Committee the company clearly suffered a loss from casualty in 1915 which it doubtless would have charged off had it had income against which to charge it, and which it should now be required to charge off as of 1915. Therefore, the action of the Unit in disallowing the amount of expenditures for replacement charged to expense in 1917 appears correct.

The Committee therefore recommends that the action of the Unit be sustained.

SECTION 215, ARTICLE 293: Capital expenditures.

(See 23–20–988; sec. 219, art. 343.) Deductibility of expenses of administration in computing income of estate.

SECTION 215, ARTICLE 294: Premiums on business insurance.

(See 12–20–793; sec. 213(b), art. 71.) Premiums paid by employer on group life insurance covering lives of employees.

SECTION 215, ARTICLE 294: Premiums on business insurance. 22–20–972 T. D. 3019

Article 294 of Regulations 45 is hereby amended to read as follows:

ART. 294. *Premiums on business insurance.*—Premiums paid by a taxpayer on an insurance policy on the life of an officer, employee, or other individual financially interested in the taxpayer's business, for the purpose of protecting

the taxpayer from loss in the event of the death of the officer or employee insured are not deductible from the taxpayer's gross income. If, however, the taxpayer is in no sense a beneficiary under such a policy, except as he may derive benefit from the increased efficiency of the officer or employee, premiums so paid are allowable deductions. See articles 33 and 105 to 108. In either case the proceeds of such policies paid upon the death of the insured may be excluded from gross income if the beneficiary is an individual, but must be included in gross income if the beneficiary is a corporation. See section 213(b)(1) and articles 72 and 541.

SECTION 216.—CREDITS ALLOWED.

SECTION 216, ARTICLE 301: Credits against net income. 4–20–706 O. D. 383

(Also Section 236, Article 591.)

Individuals are entitled to a credit for the purposes of the normal tax, of dividends, regardless of the amount of such dividends, received from a foreign corporation taxable upon income from sources within the United States, irrespective of the amount of such income. This applies equally to the Revenue Acts of 1916, 1917, and 1918. The same credit is allowed to corporations under the Revenue Act of 1917, for the purpose of the 4 per cent war income tax imposed by section 4 of that Act, but not for the purpose of the 2 per cent tax imposed by section 10(a), Revenue Act of 1916 as amended by the Revenue Act of 1917.

SECTION 216, ARTICLE 302: Personal exemption of head of family. 13–20–809 O. D. 422

A widower who maintains a home and supports his daughter therein is held to be "head of a family" notwithstanding that the daughter is over 18 years of age, receives nominal income from other sources, and is neither physically nor mentally incapable of self support.

SECTION 216, ARTICLE 302: Personal exemption of head of family. 17–20–886 O. D. 474

A widow has a child over 18 years of age who is away from home attending school. The child has separate income in excess of $1,000 a year but insufficient to pay half the cost of its support, the balance being contributed by the mother, who maintains the home. The child made an income tax return claiming an exemption of $1,000. The widow is considered "head of a family" within the meaning of section 216(c), Revenue Act of 1918, and is entitled to a personal exemption of $2,000 in making her return. The fact that a child under such circumstances has separate income or receives support from other sources does not preclude the parent from claiming exemption as "head of a family" provided the child is in a material degree dependent on the parent for support.

SECTION 216, ARTICLE 303: Personal exemption of married person. 1-20-657 O. D. 357

Unavoidable absence of a wife, due to the "World War," will not preclude a husband from claiming the joint personal exemption of $2,000.

SECTION 216, ARTICLE 307: When nonresident alien individual entitled to personal exemption. 2-20-675 O. D. 364

Under the income tax law of Porto Rico which became effective June 26, 1919, citizens of the United States who are nonresidents as to Porto Rico are allowed the same personal exemption and credit for dependents which are allowed to citizens and residents of Porto Rico.

Citizens of Porto Rico who are treated as nonresident aliens, as to the United States for income tax purposes, may claim the benefit of personal exemption and credit for dependents in computing income tax liability to the United States for 1918 and subsequent years.

SECTION 216, ARTICLE 307: When nonresident alien individual entitled to personal exemption. 5-20-718 O. D. 391

The provisions in Treasury Decision 2922 granting personal exemption and credit for dependents to citizens and subjects of the countries enumerated in classes (a) and (b), article 307, Regulations 45, is retroactive and is applicable to the year 1918 as well as 1919, except where the classification of a country has been changed because of a change in the law of such country. In cases where excess income tax has been paid for the year 1918, due to the official data not having been received at this office in regard to personal exemption, claims for refund on Form 46 should be filed with the collector of internal revenue to whom the income tax was paid.

SECTION 216, ARTICLE 307: When nonresident alien individual entitled to personal exemption. 7-20-741 T. D. 2970

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; Bolivia; Bosnia; Brazil; Bukowina; Canada; Carinthia; Carniola; China; Chile; Cuba; Czecho-Slovakia, including Bohemia, Moravia and Slovakia; Dalmatia; Denmark; Ecuador; Egypt; France; Galicia; Goritz; Gradisca; Greece; Guatemala; Herzegovina; Istria; Lower Austria; Luxemburg; Mexico; Montenegro; 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; Switzerland; 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 satisfies the similar credit requirement of the statute, but do not allow a credit for dependents: Bachka; Banat of Temesvar; Croatia; Finland; India; Italy; Salvador; Slavonia; 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. 14–20–831 O. D. 437

The British Colony of Bermuda imposes no income tax. Therefore citizens or subjects of Bermuda who are nonresident aliens as to the United States may claim the benefit of the personal exemption and credit for dependents in computing their income tax liability to the United States.

SECTION 216, ARTICLE 307: When nonresident alien individual entitled to personal exemption. 16–20–864 O. D. 466

As the Government of the Bahama Islands imposes no income tax, citizens or subjects of that British colony who are nonresident aliens as to the United States may claim the benefit of the personal exemption and credit for dependents in computing their income tax liability to the United States.

SECTION 216, ARTICLE 307: When nonresident alien individual entitled to personal exemption. 24–20–1004 O. D. 547

Since the income tax law, which was passed by the Government of Jamaica in 1919, allows to nonresidents who receive income from sources within Jamaica the same personal exemption and credit for dependents as are allowed to citizens or residents of Jamaica, it is held that Jamaica satisfies the similar credit requirements of section 216(e) of the Revenue Act of 1918. Consequently the personal exemption and credit for dependents should be allowed to nonresident aliens who are citizens of Jamaica in computing their income tax liability to the United States. The income tax law of Jamaica is applicable to 1919 and subsequent years.

SECTION 216, ARTICLE 307: When nonresident alien individual entitled to personal exemption. 24–20–1005 O. D. 548

Inasmuch as Lithuania imposes no income tax, it satisfies the similar credit requirement of section 216(e) of the Revenue Act of 1918, and nonresident aliens as to the United States, who are citizens of Lithuania, are entitled to a personal exemption and credit for dependents in determining their tax liability to the United States.

SECTION 217.—NONRESIDENT ALIENS: ALLOWANCE OF DEDUCTIONS AND CREDITS.

SECTION 217, ARTICLE 312: Who is a nonresident alien individual. 14–20–832 O. D. 438

As exemption from military service under the Selective Service Act did not depend on whether the alien was a resident or a nonresident as those terms are used in the income tax Acts and regulations, the fact that an alien was placed in class 5 under the provisions of that Act has no direct bearing on his status for income tax purposes. However, if the registrant in his affidavit claiming exemption from military service or in any other affidavit has made any statement as to his intention to remain in the United States, such statement should be given due weight in determining his classification as a resident or nonresident for income tax purposes.

SECTION 217, ARTICLE 312: Who is a nonresident alien individual.

(See 16–20–867; sec. 250, art. 1013.) Status of alien leaving the United States during taxable period.

SECTION 217, ARTICLE 312(a): Alien seamen, when to be regarded as residents. 23–20–987 O. D. 536
(Also Section 260, Article 1121.)

Since Porto Rico has its own revenue system and laws, and since section 1 of the Revenue Act of 1918 defines the term "United States" to mean the States, the District of Columbia, and the Territories of Alaska and Hawaii, excluding other places, it is held that for the purposes of the Revenue Act of 1918, vessels plying between the continental United States and Porto Rico are engaged in "foreign trade" within the meaning of article 312(a), added to Regulations 45 by Treasury Decision 2869, and that wages earned by persons serving aboard such vessels do not constitute income from sources within the United States. A citizen and resident of Porto Rico employed as seaman aboard such a vessel and who has not established himself otherwise as a resident of the United States occupies the status of a nonresident alien for revenue purposes.

SECTION 217, ARTICLE 313: Proof of residence of alien. 6-20-731 O. D. 400

Aliens who have established a residence in the United States with the intention of making this country their home and who have done nothing to indicate that they have planned to give up their residence in the United States, are considered resident aliens for income tax purposes. The fact that Germans, who were resident aliens of the United States prior to the war with Germany, were registered as alien enemies will not deprive them of their status as residents for income tax purposes if the conduct, acts, and declarations of the aliens indicate their intention to maintain their status as residents.

SECTION 217, ARTICLE 313: Proof of residence of alien. 19-20-921 O. D. 498

An alien who established a residence in the United States in 1910 and subsequently acquired property interests in this country, enlisted in the army of his native country in 1917, and served abroad until 1919, when he returned to the United States in accordance with an intention to do so expressed prior to his departure.

Held, that his status of resident alien was not lost by reason of the temporary absence abroad and that he should render returns as a resident alien, including in gross income the compensation received for service in the foreign army, as well as his taxable income from all other sources.

SECTION 218.—PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS.

SECTION 218, ARTICLE 321: Partnerships.

(See 8-20-760; sec. 335, art. 951.) Computation of income subject to excess profits tax under the Revenue Act of 1917 in the case of a partnership having a fiscal year ended in 1917.

SECTION 218, ARTICLE 321: Partnerships.

(See 12-20-794; sec. 301, art. 711.) Taxability under Revenue Act of 1917 of partnership which was dissolved in July, 1917.

SECTION 218, ARTICLE 321: Partnerships.

(See 14-20-820; sec. 1, art. 1507.) Definition of partnership.

SECTION 218, ARTICLE 322: Distributive shares of partners. 1-20-658 O. 972

INCOME TAX: SECTION 8(e) REVENUE ACT OF 1916, AS AMENDED.

Partnerships: Determination of distributive shares of partners.—(1) Under Section 8(e) of the Revenue Act of 1916, as amended, the general rule applicable to the ordinary case is that the individual

partner must report his distributive share of the partnership income, whether distributed or not, as income of the year when it was accumulated by the partnership. Part (1) of Law Opinion 689 overruled.

(2) In case the partnership establishes a fiscal year different from that of the individual partner he shall report as income his distributive share of the net income of the partnership for the accounting period of the partnership ending within the year upon the basis of which the partner's net income is computed.

(3) In case the partnership fails to close its accounts and to determine the distributive shares of the partners at the close of its established accounting period, the above rules shall nevertheless apply, and the individual partner's net income shall be computed as if the books of the partnership had been closed at the end of its established fiscal year. Law Opinion 324 and part (3) of Law Opinion 689 overruled.

(4) Where a partnership kept its accounts on a calendar year basis, but due to the death of the principal partner, did not close its books on December 31, 1916, but did close them on January 31, 1917, the distributive shares of the individual partners shall be determined as if the books had been closed on December 31, 1916, and shall be reported as income for the calendar year 1916, taxable at the 1916 rates.

Section 8(e) of the Revenue Act of 1916 reads in part as follows:

> 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 title.

This section was amended by the Revenue Act of 1917 by the addition of the following sentences:

> A partnership shall have the same privilege of fixing and making returns upon the basis of its own fiscal year as is accorded to corporations under this title. If a fiscal year ends during nineteen hundred and sixteen or a subsequent calendar year for which there is a rate of tax different from the rate for the preceding taxable year—(1) the rate for such preceding calendar year shall apply to an amount of each partner's share of such partnership profits equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year; and (2) the rate for the calendar year during which such fiscal year ends shall apply to the remainder.

In Law Opinion 689 this amendment was held to be retroactive and to affect established fiscal years ending during 1916.

Three situations may arise: (1) The partnership and the individual partners may both report on the basis of the calendar year so that their taxable years coincide; (2) Under the amendment above quoted the partnership may establish a fiscal year, so that the accounting periods of the partnership and the individual partner would not coincide. Prior to 1918 all individuals were required to report on the basis of the calendar year; (3) The partnership may not close its books at the end of its established accounting period, so that the distributive shares of the partners as shown by such closing would be for a period of more than 12 months.

1. Where both the partnership and the partners report on the basis of the calendar year the situation is fairly well settled. It was held in Law Opinion 689 that:

Income from a partnership accrues to the individual partner at the time his distributive share is determined and reducible to possession.

In that opinion this principle was applied so that if the books of the partnership were not closed or the closing of such books was greatly delayed, the individual partner was not required to make a return of partnership profits at that time. But when the books were closed (for a period of more than 12 months) the individual partner was taxed upon his entire distributive share of the partnership profits for such period at the rates in force at the time the books were closed. This holding was virtually overruled in Advisory Tax Board Recommendation 64, which held that under the Revenue Act of 1916 and the Revenue Act of 1916 as amended by the Revenue Act of 1917, 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 where the partnership had established a fiscal year different from that of the individual partner.

This ruling was based largely upon the decision in *United States* v. *Coulby*, 251 Fed. 982, affirmed by the Circuit Court of Appeals, 258 Fed. 27. That case arose under the Act of October 3, 1913, and involved the liability of partners to report for normal tax their share of dividends received by the partnership from taxable corporations. That law contained no specific provision on the subject. If the dividends had been received directly by the partners as individuals instead of indirectly through the partnership, such dividends would have been exempt from normal tax. The Government contended that such income lost its identity when received by the partnership and that when considered as income of the individual partners it no longer retained its character as corporate dividends. The District Court, 251 Fed. 984, 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.

It follows, from these considerations, that legally the defendant's share of the gains and profits of P. M. Co., derived from corporations taxable on their net income, is to be treated as if the same had been received by him directly from the taxpaying corporations.

The Circuit Court of Appeals, 258 Fed. 28, affirmed this decision, using the following language:

The facts of the case and the question involved, as well as the manner in which the issue was made and tried, are fully set out in the opinion of Judge Westenhaver; and in view of his discussion of the Income Tax Act of 1913, and of the effect upon that Act of the later one of 1916 (Act Sept. 8, 1916, c. 463, 39 Stat. 756), an opinion here would not accomplish any useful end. We concur in and adopt the conclusion reached. However, the statement made in the opinion that a partnership has no legal existence, aside from the members who compose it, is too broad, as, for instance, in view of the Bankruptcy Act (Act July 1, 1898, c. 541, 30 Stat. 544; Comp. St. sec. 9585 et seq.), yet as applied to the particular portion of the statute and the question in hand it is correct, and with this explanation we approve the reasoning of the opinion.

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. The general rule, therefore, applicable to the ordinary case, is that the individual partner must report his distributive share of the partnership income, whether distributed or not, as income of the year when it was accumulated by the partnership.

2. In the case where the partnership establishes a fiscal year different from that of the individual partners the amendment in Section 8(e) provides for an exception to the general rule above stated. It is obvious for practical reasons that in such a case it is desirable that the taxpayer be relieved of the obligation of determining his share of the partnership's net income at a time when the books have not been closed. That statute, therefore, infers that in such a case the individual partner shall report as income his distributive share of the net income of the partnership for the accounting period of the partnership ending within the year upon the basis of which the partner's net income is computed. However, the statute specifically provides for a compensating adjustment of the rates of taxation, so that the individual partner is taxed at the rate which prevailed during the period when such income was accumulated by the partnership, although for practical reasons the reporting of such income for taxation is postponed. (Advisory Tax Board Recommendation 64; Law Opinion 689.) The fiscal year of the partnership here referred to is a year of 12 months.

3. In case the partnership does not close its books for a 12-months period, question arises as to what rule should apply. The provision as to fiscal years is inapplicable, because the fiscal year is a 12-months period. (Law Opinion 689.) Should we hold that in spite of the practical difficulty the individual partners must report their distributive share of the partnership net income as if the books had been closed at the proper time? Or should we postpone the accounting for income in such a case until the books actually are closed, and tax the entire distributive share at the rates then in force on the theory that the provision for an adjustment of rates applies only in case of a fiscal year and that a period longer than 12 months is not a fiscal year? With reference to this situation Law Opinion 689 says:

(3) It does not follow from the modification of Law Opinion 324 above stated that the conclusion of that opinion is incorrect. The partnership there under consideration closed its books on November 30, 1916, and ascertained its net profits for the two business years preceding. The "fiscal year" referred to in the amendment to Section 8(e) of the Revenue Act of 1916, is a year of twelve months. The accounting period recognized by the income tax Acts is the calendar year of twelve months. The fiscal year is a substitute therefor and is obviously intended to be of equal length. A partnership which ascertains its profits for a period longer than twelve months can not be said to have "fixed" its fiscal year within the meaning of the amendment. Moreover, the method of apportioning partnership profits among individual partners is not adapted to the apportionment of such profits over a period of more than twelve months. Furthermore, a partnership which by failure to ascertain its profits annually makes it possible for the partners to escape or postpone taxation is not ordinarily the kind of a partnership for which the relief provided for by the amendment is intended. It follows that the provision for apportioning a partner's profits over parts of two calendar years does not apply to an accounting period longer than twelve months. Since in the case considered in Law Opinion 324 the accounting period was more than twelve months there was no authority

for apportioning profits and all such profits were taxable in the year in which the partners' shares were ascertained. The conclusion of Law Opinion 324 is therefore affirmed.

In view of the Coulby case it is believed that this result is wrong, and this part of Law Opinion 689 and Law Opinion 324 are hereby overruled. It is true that the fiscal year referred to in the amendment of Section 8(e) of the Revenue Act of 1916 is a year of 12 months. Partnerships have the option of establishing a fiscal year or of reporting on the basis of the calendar year. The law, however, imposes an annual tax and contemplates an annual accounting for income. Taxpayers are required, therefore, to ascertain their income annually and can not postpone taxation by refusing to close their accounts. This principle is applicable to partnerships as well as to individuals and corporations. It is realized that there is some practical difficulty in applying this rule, but such difficulty arises solely from the failure or refusal of the partnership to close its accounts at the regular time and is a difficulty which is apt to arise with reference to any taxpayer and is not peculiar to partnerships.

It is therefore held that the mere failure of the partnership to close its books at the end of its fiscal year will not change the tax liability of the individual partners, who will be required to report their distributive share of the partnership profits as if the partnership had closed its books as of the end of its established accounting period. This rule applies the principle adopted in *United States* v. *Coulby* that for the purpose of income taxes we should look through the partnership and treat the income as if received directly by the individual partners. This rule is consistent with and gives effect to the fiscal year provision introduced by the amendment in 1917, in which Congress when departing from the principle that partnership profits must be reported by the individual partners as if received directly by them specifically provides for an adjustment in rates so that such income should be taxed at the rates which prevailed when the income was accumulated by the partnership. It avoids the illogical and often unjust result of the old rule which enabled persons to postpone the time for payment of taxes by failing to close their books and because of the progressive rates and new laws imposing heavier taxes imposed an unduly high tax when the books were closed.

In this case, therefore, the distributive shares of the partners for the year ending December 31, 1916, should be determined from the best evidence available and should be treated as income of such individual partners for the calendar year 1916, taxable at the 1916 rates.

It is therefore held (1) that under Section 8(e) of the Revenue Act of 1916, as amended, the general rule applicable to the ordinary case is that the individual partner must report his distributive share of the partnership income, whether distributed or not, as income of the year when it was accumulated by the partnership; part (1) of Law Opinion 689 overruled; (2) that in case the partnership establishes a fiscal year different from that of the individual partner he shall report as income his distributive share of the net income of the partnership for the accounting period of the partnership ending within the year upon the basis of which the partner's net income is computed; (3) that in case the partnership fails to close its accounts and to determine the distributive shares of the partners at the close of its established accounting period, the above rules shall neverthe-

less apply and the individual partners' net income shall be computed as if the books of the partnership had been closed at the end of its established fiscal year; Law Opinion 324 and part (3) of Law Opinion 689 overruled; (4) that where a partnership kept its accounts on a calendar year basis, but due to the death of the principal partner did not close its books on December 31, 1916, but did close them on January 31, 1917, the distributive shares of the individual partners shall be determined as if the books had been closed on December 31, 1916, and shall be reported as income for the calendar year 1916, taxable at the 1916 rates.

SECTION 218, ARTICLE 322: Distributive shares of partners. 1–20–659 A. R. M. 13

DECISION UNDER ACT OF OCTOBER 3, 1913.

Method of computing the tax due under the Act of October 3, 1913, by the individual members of a partnership under the Coulby decision, 251 Fed., 982, Treasury Decision 2858 (7–19–294).

A partnership received large amounts as dividends. These amounts under the ruling of this office were held to have lost their identity as dividends when received by individual members thereof, who were required to return and pay both normal and additional tax upon their distributive shares of all the partnership income, including such dividends. The District Court rendered a decision which was affirmed by the Court of Appeals and acquiesced in by this office, holding, in effect, that the Act of 1913 was 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, and that each individual partner was therefore exempt from normal tax upon his share of the dividends received by the partnership.

In the case of a partnership sustaining operating losses the question arises as to whether or not the full distributive share of dividends received by the partnership should be included in the amount reported on line 25, page 2, of the form for 1913, eliminating any entry on line 19. The effect of this, if nothing further is done, would be to return the entire distributive share of the dividends received by the partnership as liable to surtax, no notice being taken of the operating losses.

The Committee is of the opinion that the correct method of treatment is to include on line 25 the total distributive share of dividends and to enter on line 32 a proportionate share of the losses sustained, which would have the effect of including, for surtax purposes only, the net distributive share of the partnership income.

SECTION 218, ARTICLE 324: Taxation of partners in partnership with fiscal year ending in 1918. 14–20–833 O. 1016

(Also Section 205, Article 1621.)

INCOME TAX: SECTION 8(e), REVENUE ACT OF 1916, AS AMENDED BY SECTION 1204, REVENUE ACT OF 1917.

Where the fiscal year of a partnership ended during the year 1916, the rate of tax for the calendar year 1915 applied to an

amount of each partner's share of the partnership profits proportionate to the ratio which the part of the fiscal year falling within the calendar year 1915 bore to the full fiscal year. Solicitor's Memorandum 301 and part (4) Law Opinion 689 modified.

The question is again raised as to the rates of taxation applicable to the distributive shares of members of a partnership whose fiscal year ended April 30, 1916.

Section 8(e) of the Revenue Act of 1916 provides:

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 title; * * *

This provision was amended by section 1204 of the Revenue Act of 1917 by adding thereto the following:

If a fiscal year ends during nineteen hundred and sixteen, or a subsequent calendar year for which there is a rate of tax different from the rate for the preceding calendar year, then (1) the rate for such preceding calendar year shall apply to an amount of each partner's share of such partnership profits equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year; and (2) the rate for the calendar year during which such fiscal year ends shall apply to the remainder.

In Law Opinion 689, part (2), it was held that section 1204 of the Revenue Act of 1917 in so far as it amended section 8(e) of the Revenue Act of 1916 was retroactive and applicable to established fiscal years ended during 1916. Law Opinion 972, after holding that the statutes required that where a partnership had established a fiscal year, an individual partner should report as income his distributive share of the net income of the partnership for the accounting period of the partnership ended within the year upon the basis of which the partner's net income was computed, added:

However, the statute specifically provides for a compensating adjustment of the rates of taxation, so that the individual partner is taxed at the rate which prevailed during the period when such income was accumulated by the partnership, although for practical reasons the reporting of such income for taxation is postponed. Advisory Tax Board Recommendation 64; Law Opinion 689.

It is clear that the above conclusions correctly construed the amendment to section 8(e) of the Revenue Act of 1916 contained in section 1204 of the Revenue Act of 1917. In fact, the language of section 1204 that "if a fiscal year ends during 1916, * * * (1) the rate for such preceding calendar year shall apply to an amount of each partner's share of such partnership profits equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year" is so clear as to leave no room for the application of rules of construction.

It is therefore held that where the fiscal year of a partnership ended during the year 1916, the rate of tax for the calendar year 1915 applied to an amount of each partner's share of the partnership profits proportionate to the ratio which the part of the fiscal year falling within the calendar year 1915 bore to the full fiscal year. Solicitor's Memorandum 301 and part (4) of Law Opinion 689 are hereby modified to conform to this opinion.

SECTION 218, ARTICLE 334: Taxation of stockholders of personal service corporation with fiscal year ending in 1919. 15–20–850 O. D. 453
(Also Section 205, Article 1625.)
(Also Section 213(a), Article 52.)

A personal service coorporation closed its books January 31, 1919, and December 31, 1919, having secured permission to change its accounting period. A stockholder of this corporation keeping his books on a calendar year basis must include in his return for 1919 his share of the earnings of the corporation (whether distributed or not) for the fiscal year ended January 31, 1919, and for the 11-month period ended December 31, 1919. That portion of the amount received attributable to 1918 will be subject to tax at the rates in effect for that year as outlined in article 334, Regulations 45.

SECTION 219.—ESTATES AND TRUSTS.

SECTION 219, ARTICLE 341: Estates and trusts. 15–20–851 O. D. 454
(Also Section 212, Article 23.)

Interest accrued on bonds owned by an individual at the date of his death should be included in the return filed for the decedent by the executor or administrator if the books of the decedent were kept on an accrual basis; if the books were kept on the basis of actual receipts and disbursements, only the amount of interest on coupons falling due prior to decedent's death should be included. Interest accruing or falling due subsequent to the decedent's death should be reported in the return of the estate.

SECTION 219, ARTICLE 341: Estates and trusts.

(See 16–20–875; sec. 214(a) 3, art. 134.) Treatment of Federal estate tax in computing net income of estates subject to Federal income tax.

SECTION 219, ARTICLE 341: Estates and trusts.

(See 17–20–877; sec. 201, art. 1548.) Liquidation of corporation whose sole stockholder is an estate.

SECTION 219, ARTICLE 341: Estates and trusts.

(See 18–20–896; sec. 213(b), art. 84.) Taxability of income from property bequeathed to a State institution.

SECTION 219, ARTICLE 342: Estates and trusts taxed to fiduciary. 9–20–774 O. 1001

INCOME TAX: ACT OF 1913, PARAGRAPH D; REVENUE ACT OF 1916, SECTION 2; REVENUE ACT OF 1916, AS AMENDED BY THE REVENUE ACT OF 1917, SECTION 2.

The income of a trust estate which is accumulated and added to the corpus, the beneficiary of which is unascertained, is taxable as income of the trust. Law Opinion 322 modified.

Opinion is requested whether the income from a certain estate held in trust is taxable to the fiduciary or to the beneficiary, the terms of the trust instrument being more fully set out below.

Paragraph D of the Act of 1913, provides:

* * * guardians, trustees, executors, administrators, agents, receivers, conservators, and all persons, corporations, or associations acting in any fiduciary capacity, shall make and render a return of the net income of the person for whom they act, subject to this tax, coming into their custody or control and management, and be subject to all the provisions of this section which apply to individuals:

Section 2 of the Revenue Act of 1916, and of the Revenue Act of 1916, as amended by the Revenue Act of 1917, provides:

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 as 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.

It appears that A provided in his will for a trust of the residue of his estate to vest in B upon B attaining the age of 25 years, but in the event of his death before reaching the age of 25 the property to go to C or her heirs, if any, and if C had no heirs, then to certain charitable corporations that are exempt from income tax. The trustees were given discretion whether to use any of the income of the trust for maintenance or education of B, or to accumulate and add it to the trust estate. It further appears that no part of the income of the trust estate was paid to B, but that the whole income was added to the corpus of the trust.

B was the beneficiary of another trust created by D. The income from this trust was returned by E, as guardian of B. The revenue agent was instructed to investigate the returns of these two trusts for the years 1913 to 1917, inclusive, and to combine the incomes from them, treating the annual totals as one income each year. This is permissible for the years 1913 to 1915, inclusive, only if the trust created by A is a source of income to B. As a matter of fact, the income was not received by B. As a matter of interpretation of the will, it is clear that the income can not be said to have accrued to him. Moreover, this minor might never enjoy the accumulated income. His ultimate enjoyment of such income was contingent upon his attaining the age of 25 years. In this connection the case of *Vanderbilt* v. *Eisman*, 196 U. S. 480, is persuasive. This case arose under the legacy act of 1898. The legatee was to receive a certain legacy upon reaching a specified age. The court held that no tax should be imposed upon this legacy, because of the uncertainty of enjoyment.

It is held that the income resulting from the trust during the years 1913 to 1915, inclusive, should be treated as income received by it, as provided in T. D. 2231, which contains the following provisions:

When the beneficiary is not in esse and the income of the estate is retained by the fiduciary, such income will be taxable to the estate as for an individual and the fiduciary will pay the tax, both normal and additional.

For the year 1916 the Revenue Act of 1916 controls, and for the year 1917 the Revenue Act of 1916, as amended by the Act of 1917, controls. The provisions of section 2 of each of these Acts are identical and very clear. Under these provisions, trusts, the incomes from which are accumulated, are treated as entities.

Law Opinion 322 reaches the conclusion that the income of both of these trusts is taxable to the beneficiary, but the facts as stated in it are in part erroneous. It assumes that under both of the trusts the beneficiary could at any time demand the accumulated balance. In the case of the trust created by A, as stated above, B did not have such right. Law Opinion 322 must therefore be modified to this extent.

SECTION 219, ARTICLE 342: Estates and trusts taxed to fiduciary.

(See 12–20–792; sec. 202, art. 1562.) Taxability of gain from sale of stock by trustees under will.

SECTION 219, ARTICLE 342: Estates and trusts taxed to fiduciary. 13–20–810 A. R. M. 37

The Committee has been requested to render a decision upon the following questions:

1. Whether the undistributable income of a trust or estate under the control of a citizen or resident fiduciary is taxed in the same manner as income accruing to an unmarried resident individual regardless of the citizenship or residence of the creator of the trust or estate and regardless of the citizenship or residence of persons for whom the income is accumulated for future distribution, under the terms of the will or trust.

2. Whether in such case the estate is entitled to a personal exemption of $1,000 regardless of the citizenship or residence of the creator of the trust or regardless of the ultimate beneficiaries or distributees.

3. Whether the income is taxable in such cases where the fiduciary is a nonresident alien regardless of the residence or citizenship of the creator of the trust or estate or regardless of the citizenship of the ultimate beneficiaries or distributees.

In passing on these inquiries, the provisions of the Revenue Act of 1918 relating to estates and trusts have been considered.

Section 219 provides in part as follows:

(a) 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—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(c) In cases under paragraphs (1), (2), or (3) of subdivision (a) the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary, except that in determining the net income of the estate of any

deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir, or other beneficiary. In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.

Section 216 provides that, for the purpose of the normal tax, a single person is entitled to a specific exemption of $1,000 plus $200 for each person dependent upon and receiving his chief support from the taxpayer if such dependent is under 18 years of age or is incapable of self-support because mentally or physically defective. This provision of law is applicable in the case of a nonresident alien individual who is a citizen or subject of a country which imposes an income tax and allows a similar credit to citizens of the United States not residing in such country.

The provisions of (1), (2), and (3), subdivision (a) of section 219, quoted above, recognize a taxable entity, but in subdivision (4), quoted above, no such entity is recognized for the purpose of taxation.

A general principle may be stated that if an estate is in process of administration and such administration is within the jurisdiction of the United States, the entire amount of net income from all sources not distributed or credited to beneficiaries, as provided in (c), quoted above, is subject to tax. After an estate is distributed, or if property is held by trustees for the benefit of beneficiaries and the income of the trust is to be distributed periodically, the trustees are not considered a legal entity within the meaning of the taxing Act. The income received by the beneficiaries in such case may properly be traced through the trustee directly to its source.

The above stated principle is recognized by Law Opinion 397, in which it was held that dividends on stock and interest on notes of corporations organized in the United States, but doing no business and owning no property therein, paid to nonresident alien individuals or corporations are not subject to taxation as income received from sources within the United States.

Article 92 of Regulations 45 sustains this thought by providing that salaries, wages, commissions, and rents paid by domestic business enterprises to nonresident alien employees for services rendered entirely in a foreign country or for property located in a foreign country are not subject to tax as income from a source within the United States.

After analyzing the inquiries presented, the Committee has reached the following conclusions:

1. That the undistributed net income of a trust estate under the control of a resident fiduciary and subject to the jurisdiction of a State or Territory of the United States, or to the District of Columbia, is taxable in the same manner as income accruing to an unmarried resident individual, irrespective of the fact that the creator of the trust may be a nonresident alien and irrespective of the fact that the ultimate beneficiaries may be nonresident aliens. The exemption to which a single person is entitled may properly be claimed regardless of the citizenship or residence of the creator of the trust or of the beneficiaries for whom the income is retained.

2. That the income of an estate in process of administration in the courts of a State or Territory of the United States or of the District of Columbia by resident fiduciaries is taxable as an entity, irrespective

of the fact that the decedent may have been a nonresident individual and the beneficiaries or distributees may be nonresident aliens and the income may be, in part or whole, derived from foreign sources. The same specific exemption may properly be claimed as provided for under (1) above. The income taxable to the estate is determined after applying the provisions of section 219(c), quoted above.

3. That nonresident alien fiduciaries of trusts subject to the jurisdiction of a foreign country are taxable on undistributed net income from sources within the United States, irrespective of the fact that the creator of the trust or estate may be either a citizen or resident of the United States or a nonresident alien and the beneficiaries may be either citizens or residents of the United States or nonresident aliens. An exemption allowed a single person may properly be claimed, provided the fiduciary is a citizen or subject of a country which imposes an income tax and allows a similar credit to citizens of the United States not residing in such country.

4. That the income of estates in process of administration in the courts of a foreign country by nonresident alien fiduciaries is taxable as an entity in so far as the income received is from sources within the United States, irrespective of the fact that the decedent may have been either a nonresident alien or citizen of the United States and the beneficiaries in the distribution may be either nonresident aliens or citizens or residents of the United States. The same specific exemption as provided for in (3) above may be claimed under the same conditions and limitations.

SECTION 219, ARTICLE 342: Estates and trusts taxed to fiduciary. 20-20-939 O. D. 507

Under the will of A, property was given to the X Trust Company to be held in trust for his wife and daughter for the period of their lives, the income accruing to be divided equally between them. It was provided that upon the death of the wife she might appoint a certain portion of the estate by her will and a similar provision was made in the case of the daughter. The principal remaining at the termination of the trust was directed to be paid over to certain charitable and educational corporations.

In case the corpus of the estate remaining upon the death of the life beneficiaries was not in excess of the amount which might be appointed by the life beneficiaries in their respective wills the charitable and educational corporations would, of course, receive no part thereof, since it would go to the persons designated by the wife and daughter under the power of appointment given to them by the will of the testator.

In 1918, prior to the termination of the trust, a certain sum was received by the trustee from the sale of subscription rights on stock, which sum was added to the corpus of the estate. The question presented is whether the proceeds so received by the trustee and added to the corpus of the estate are taxable inasmuch as such tax would operate to diminish the sum eventually to be distributed to charitable corporations which are exempt from tax.

Assuming that the subscription rights on stock which were sold were granted directly to the X Trust Company as trustee, it is held

that the entire proceeds from their sale, which was added to the corpus of the estate for future distribution, must be reported by the trustee in a return for the estate on Form 1040, revised, together with all other income so accumulated during the taxable year. Such income is subject to both normal tax and surtax in the hands of the trustee at the rates prescribed by law for that year.

SECTION 219, ARTICLE 342: Estates and trusts taxed to fiduciary. 26–20–1029 O. D. 560

Profit from the sale of property during life tenancy, which profit is held for future distribution to remaindermen, is taxable as an entity in the hands of the trustees of the estate.

SECTION 219, ARTICLE 343: Decedent's estate during administration. 13–20–811 S. 1229–A

INCOME TAX: ESTATES—SECTION 2(b), REVENUE ACT OF 1916, AS AMENDED BY THE REVENUE ACT OF 1917, AND SECTION 219(a), (c), REVENUE ACT OF 1918.

Taxing Income from Real Estate to the Estate during Administration.

Where the deceased owner of real estate in the District of Columbia has not, in his will, directed the sale of real estate, or devised the same upon trust to be sold, to pay debts, legacies, or for other purposes, or done such other act as to effect equitable conversion of his real estate at his death, and the personal property is sufficient to pay all the debts and legacies, the real property does not form part of the "estate" within the language of section 2(b) of the Revenue Act of 1916, as amended, or of section 219(a), (c), of the Revenue Act of 1918, and the executor of the estate will not be required to make a single return for the income from the real estate and the personal estate of the said decedent during the administration of the estate, even though the real estate was devised to a trustee. Solicitor's Memorandum 1229 revoked.

SECTION 219, ARTICLE 343: Decedent's estate during administration.

(See 21–20–953; sec. 214(a) 2, art. 121.) Deduction of interest paid upon notes of decedent.

SECTION 219, ARTICLE 343: Decedent's estate during administration. 23–20–988 O. D. 537

(Also Section 214(a) 1, Article 101.)
(Also Section 215, Article 293.)

Taxable net income of an estate during administration is determined by subtracting from gross income ascertained as provided in section 213 of the Revenue Act of 1918, the deductions specified in sec-

tion 214. The only provision in that section by virtue of which expenses of administration are deductible is the one providing for the deduction of expenses of carrying on a trade or business. Under a liberal construction of the language used it seems possible to hold that expenses having a reasonable, proximate relation to the collection of income due an estate are deductible. An administration expense merely as such is not deductible, and this rule would exclude the deduction of ordinary executors' commissions and attorneys' fees. On the other hand, necessary expenses such as office rent or the compensation of a business agent might be deductible, the test in every case being whether the expense is an ordinary and necessary incident to the collection of income due the estate.

SECTION 219, ARTICLE 343: Decedent's estate during administration.

(See 25–20–1017; sec. 214(a) 7, art. 151. Deductibility of losses determined after decedent's death.

SECTION 219, ARTICLE 345: Estates and trusts taxed to beneficiaries. 10–20–780 S. 1344
(Also Section 225, Article 421.)

INCOME TAX: REVENUE ACT OF 1916, SECTION 1(a), SECTION 2(b), SECTION 8(c) AS AMENDED BY SECTION 1204 OF REVENUE ACT OF 1917.

Taxability to Beneficiary of Accrued Income not Withdrawn from a Trust.

1. Where a person transfers to trustees to pay to him during his lifetime so much of the income as he may demand, and to pay from time to time to him as much of the principal as such trustees might deem advisable, all unwithdrawn income at the date of the death of the settlor to become a part of the trust fund, the settlor should return in any one year all the income accruing from such trust fund whether actually withdrawn by him or not.
2. The trustees under such deed must make return of all income from the trust, but are relieved from paying a tax thereon.

Opinion is requested (1) as to whether a life beneficiary under a trust deed should return as income all that has accrued within the taxable year from the trust fund, or only such part as is withdrawn by such beneficiary; (2) as to what the duties of the trustees are, in respect to such income.

In 1912 A executed an instrument under the terms of which he transferred to designated trustees certain property, to be held by them in trust. In so far as it is necessary to refer to the terms of the trust deed in answering the question propounded, they are as follows:

The trustees were to pay A the income arising from the trust fund at whatever time he should demand payment thereof, the right being reserved to him to require payment of the whole or any portion of the income accrued at the time of such demand. The deed was not revocable, but provided that the settlor should have the right to alter or amend the terms of the instrument and to change the "uses, purposes, and provisions" of the trust. Upon the death of the settlor, the fund

was to go as directed in the instrument. As these provisions are not, however, pertinent to the present question, they will be omitted here.

Those portions of the Revenue Act of 1916, as amended by the Revenue Act of 1917, which relate to the question to be determined, are 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 two per centum upon such income; * * *

SEC. 2(b). 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; * * *

SEC. 8(c), as amended by section 1204 of the Revenue Act of 1917. Guardians, trustees, executors, administrators, receivers, conservators, and all persons, corporations, or associations, acting in any fiduciary capacity, shall make and render a return of the income of the person, trust, or estate for whom or which they act, and be subject to all the provisions of this title which apply to individuals. * * *

It will be noted that in section 1 of the Revenue Act of 1916, unlike either the 1913 or 1918 Acts, the basis of taxation is income received. The term "receipt," however, is subject to the qualification that income may be constructively as well as actually received.

In the instant case, while the unwithdrawn income in any one year is not actually received, it remains throughout that year, and throughout the settlor's life, always at his disposal, whether or not he wishes to take it. It has been held by this Bureau that accrued interest on a bank deposit allowed by the depositor to remain in the bank rather than withdrawn, is nevertheless income to such depositor (Reg. 33, revised; art. 4). There appears to be no substantial distinction between the case where accrued interest on a bank deposit is allowed to remain by the depositor in the custody of the bank and the one now under consideration.

As to the trustees' duties, it will be observed that while they are obliged to make return of the income as provided in section 8(c), as amended by section 1204 of the Revenue Act of 1917, they are not liable to pay a tax on the same, for although by section 2(b) it is provided that the income from the trust shall be subject to the normal and additional tax, by the same section it is provided that the tax is not to be assessed to the trustees where it is returned for the purpose of the tax by the beneficiary.

It is, therefore, held: (1) That where the beneficiary for life under a trust deed has the right to withdraw at any time all or any portion of the income accrued from such trust fund, and where such beneficiary in any one year exercises the right of withdrawal, as to a portion only of such accrued income, he is taxable on the basis not of such income as may have been withdrawn, but on the basis of all the income accrued; (2) the trustees under such trust deed must make return of all income from the trust, but are relieved from paying a tax thereon.

SECTION 219, ARTICLE 345: Estates and trusts taxed to beneficiaries. (Also Section 250, Article 1011.)

24-20-1006
S. 1371

INCOME TAX: ACT OF OCTOBER 3, 1913.—TRUST ESTATES. ADMINISTRATIVE: COMPROMISE.—SECTION 3229 R. S.

1. Income received by a trustee under a will prior to November 1, 1913, and by the trustee paid over to the sole beneficiary of the trust prior to that date but during the taxable year 1913 should be returned by the beneficiary as income for the purpose of the tax imposed by the Act of October 3, 1913. In such case the trustee is not required to withhold the normal tax, but should file an information return on Form 1041.

2. The Commissioner of Internal Revenue has no power under the provisions of section 3229, Revised Statutes, to compromise taxes legally due from a solvent taxpayer.

An opinion is requested in regard to an offer in compromise submitted by A.

The fundamental question involved in this case is whether for the purposes of the income tax the income received by the trustee of the estate of B during the taxable year 1913 should be combined with the income received during the same period by A, the sole beneficiary of the trust, and one deduction of $2,500 allowed, or whether the estate of B should be considered a taxable person and should therefore be required to make a separate return on Form 1040 and be allowed a separate deduction of $2,500.

The Act of October 3, 1913, makes no specific reference to the estates of deceased persons undergoing administration and to trusts for accumulation or distribution as entities or persons separate and apart from the beneficiaries. It simply provides that persons acting in a fiduciary capacity shall make a return for—

> The person for whom they act, and be subject to all the provisions which apply to individuals.

However, it has been held that the income of an estate in the course of administration is taxable under the Act of October 3, 1913, to the estate as an entity, even though wholly or partially distributed to the beneficiaries. Law Opinion 599. Under such circumstances the aggregate of individuals constituting the "estate" is the "person" for whom an executor, or administrator, as such, acts. Law Opinion 599. Similarly income received by any fiduciary or trustee which is not distributable to the beneficiary and is held for accumulation becomes an entity, the income being taxable to the estate as for an individual and the fiduciary being required to pay the tax, both normal and additional. Treasury Decisions 2231 and 2289. However, where the income received by the fiduciary is distributable or distributed to the beneficiary within the taxable year in which received, it is to be regarded as the income of the beneficiary, though subject to withholding provisions in the hands of the fiduciary. Treasury Decision 2289.

The instant case is not one of an estate undergoing administration, it being assumed that the administration was closed when all of the assets of the estate were turned over to the trustees under the will, but is one of trust pure and simple. Upon the death of the widow

of B, the creator of the trust, in 1909, the right to the entire corpus of the trust estate, together with all income accruing subsequently to that date, vested in A as sole beneficiary. He, or his guardian for him, from that date became entitled to receive the entire trust fund with all income accruing thereon. The sole duty of the trustee thereafter was to administer the estate for the purpose of its distribution to A as the sole beneficiary. The trustee, therefore, stands in the stead of the beneficiary, and under such circumstances the income accruing to the trustee is the income of the beneficiary.

It appears that the income received by the trustee during the taxable year 1913 was paid over to the beneficiary. There can, therefore, be no doubt that such income arose and accrued to the beneficiary during the taxable year 1913. Section II–A of the Act of October 3, 1913, specifically provides that the tax shall be paid upon the *entire* net income arising or accruing *from all sources.* Section II–B of the same Act very clearly provides that the income accruing from property acquired by bequest or devise shall be included in net income. It is, therefore, apparent that the income which accrued and was received by the trustee of the estate of B during the taxable year 1913 was in fact the income of A.

To hold, under the above circumstances, that the estate of B was a separate entity and subject to all the provisions applicable to individuals would be in effect to allow A a double deduction of $2,500 on the income which accrued to him during the year 1913, as well as to materially reduce the additional tax due upon his income. It is clear from the provisions of Section II–C of the Act of October 3, 1913, that only one deduction of $3,000, or the proportionate part thereof, shall be allowed to one unmarried person. To hold under the circumstances that the estate of B was a separate entity would therefore be to defeat the manifest intention of the Act.

The Act of October 3, 1913, specifically provides that the withholding of the normal tax by fiduciaries was not applicable prior to November 1, 1913. It was, therefore, proper for the fiduciary in this case not to withhold the normal tax, but an information return should have been filed by the fiduciary on Form 1041, in order to comply with the provisions of Section II–D of the Act requiring fiduciaries to make a return of the net income for the person for whom they act.

It is accordingly held that income received by a trustee under the will during the taxable year 1913 and during the same period paid over to the sole beneficiary of the trust should be included with the other income of the beneficiary for the purposes of the income tax imposed by the Act of October 3, 1913. The payment to the beneficiary having been made prior to November 1, 1913, it was proper for the fiduciary not to withhold the normal tax, but an information return should have been filed by the fiduciary on Form 1041.

It does not appear that the proponent in this case is insolvent, or even in financial difficulty. It is well established that the Commissioner of Internal Revenue has no power under the provisions of section 3229, Revised Statutes, to compromise taxes legally due from a solvent taxpayer. (16 Op. Atty. Gen. 249.)

It is, therefore, recommended that the offer in compromise submitted by proponent be rejected, and that suit should be brought to recover the full amount of the tax due to the Government.

SECTION 219, ARTICLE 347: Estates and trusts which can not be treated as a unit. 10-20-781 T. D. 2987

Regulations 45 are amended by adding thereto article 347 to read as follows:

ART. 347. *Estates and trusts which can not be treated as a unit.*—In the case of certain estates and trusts it is recognized that the estate or trust can not be treated as a unit for income tax purposes and may represent an aggregate of distinct interests to all of which the fiduciaries are responsible; in such cases the procedure stated in this article should govern. The following are recognized as cases which can not be treated as a unit and must, therefore, be governed by this article: (*a*) When there is income distributable periodically and also income which is to be accumulated in trust, held for future distribution, or added to the corpus; (*b*) when there is income distributable periodically and also income (according to the Federal income tax statutes and regulations) which is not distributable periodically under State law, e. g., gains from sale of capital assets, stock dividends; (*c*) when there is income distributable periodically and deductions (according to Federal income tax statutes and regulations) which are not deductible under State law from the distributable income, e. g., losses from the sale of capital assets, depletion, depreciation.

In ascertaining whether an estate or trust comes within any one of the cases just enumerated, the provisions of the Federal statutes and regulations—rather than the provisions of the will or trust and the provisions of State laws—shall determine what items constitute taxable gross income or allowable deductions; the provisions of the will or trust and of State laws shall determine the allocation of items of gross income or deduction; that is, to which of the different interests making up the whole such items shall be charged or allowed. In cases which are to be treated under this article, the items of gross income and deduction as determined by the Federal income tax statutes and regulations must be scrutinized and classified in accordance with the provisions of the will or trust or rules of local law into two classes, one subject to the procedure specified in subdivision (*c*) of section 219, and the other to the procedure specified in subdivision (*d*) of section 219. The result will be that the beneficiary to whom income is to be distributed periodically must include in computing his net income the amount actually distributable to him (except exempt income) even though the aggregate of the distributive shares should be larger than the net income of the estate or trust computed as a unit. Any gain, profit, or income which is not periodically distributable, must be included in computing the net income of the estate or trust so that the fiduciary will pay the tax upon any excess of the net income of the estate or trust computed as a unit over the aggregate distributive shares.

For example, a trust is created the income of which is distributable periodically for the life of the beneficiary, the remainder over to others. The trust has the following items of income: Rent, $3,000; interest, $2,000; gain on sale of capital assets, $1,500; cash dividend, $1,000; and deductions, general expenses (all deductible from distributable income), $700; depreciation, $300; loss on sale of capital assets, $3,000. Under the terms of the trust $5,300 will be distributed to the beneficiary, viz, rent, $3,000; plus interest, $2,000; plus dividend, $1,000; less general expenses, $700. The gain and loss on the sale of capital assets will be considered capital items affecting the corpus only, and the items of depreciation will not affect the amount to be distributed, there being no rule of State law or provision of the trust requiring this deduction from distributable income. In such a case the fiduciary must report on form 1041 showing a net income for the trust of $3,500, and must show as the distributive share of the beneficiary the $5,300 to which he is entitled. The beneficiary must account for the amount actually distributable to him as income, viz, $5,300, as provided in section 219 (*d*) and will be entitled to a credit of $1,000 on account of the dividends in computing the normal tax, but not to any deduction on account of depreciation or capital losses.

If there had been no loss on the sale of capital assets so that the net income of the estate or trust was $6,500, Form 1041 should show the distributive share of the beneficiary as $5,300, and the distributive share of the fiduciary as $1,200; and the fiduciary should file a separate return on Form 1040 A, reporting $1,200 for taxation.

SECTION 219, ARTICLE 347: Estates and trusts which can not be treated as a unit. 12–20–795 O. 1013

INCOME TAX: SECTION 219, REVENUE ACT OF 1918.

Estates and trusts: Determination of net income and distributive shares of beneficiaries.

Under section 219 of the Revenue Act of 1918, where an estate or trust represents different interests and is not susceptible of treatment as a unit, the fiduciary, in determining the distributive shares of the beneficiaries, shall analyze the items of gross income and deduction and shall (a) account as fiduciary for income held for future distribution or added to the corpus; (b) assign to the beneficiaries income which is distributable periodically; (c) report on Form 1041 the net income of the estate or trust computed as a unit, but show as the distributive shares of the beneficiaries the amounts of income which should be periodically distributed to them (whether distributed or not); (d) report on Form 1041 any excess of the net income of the estate or trust over the aggregate distributive shares of the individual beneficiaries as the distributive share of the fiduciary; (e) if such amount exceeds $1,000, make a separate return on Form 1040 or 1040–A including such income.

The result of this will be that each beneficiary must include in computing his net income the entire sum which should be periodically distributed to him (whether distributed or not) from the estate or trust as income (other than exempt income) and no more than such sum.

Question has arisen as to the taxation of estates and trusts and the beneficiaries thereof under section 219 of the Revenue Act of 1918 in the following situations. In all of these cases the income in whole or in part is periodically distributable to the beneficiaries.

1. Part of the income is to be distributed and part to be held for future distribution or added to the corpus.

2. Items of gross income (according to income tax statute) are considered capital by the probate courts and are not distributed to the life beneficiaries, but are added to the corpus, e. g., gains from sale of capital assets, stock dividends.

3. Items of deduction (according to income tax statute) are considered capital deductions by the probate courts and are deducted from the corpus and not from the distributable income, e. g., loss from sale of capital assets.

4. Items of deduction (according to income tax statute) are disregarded by the State courts in making distributions to the beneficiaries, there being no provision of the will or trust or rule of law requiring their deduction from distributable income, e. g., depreciation or depletion.

5. There may be a combination of these questions in one trust or estate.

Section 219 of the Act provides:

(a) 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—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income *accumulated in trust* for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income *held for future distribution* under the terms of the will or trust; and

(4) Income which is *to be distributed* to the beneficiaries *periodically*, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income of the estate or trust for which he acts. *The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212,* except * * * and in cases under paragraph 4 of subdivision (a) of this section the fiduciary shall include in the return a statement of *each beneficiary's distributive share of such net income,* whether or not distributed before the close of the taxable year for which the return is made.

(c) In cases under paragraph (1), (2), or (3) of subdivision (a) the tax shall be imposed *upon the net income of the estate or trust* and shall be paid by the fiduciary, except that in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir, or other beneficiary. In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.

(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration of settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, 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,* 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 estate or trust* is computed, then *his distributive share of the net income of the estate or trust* for any accounting period of such estate or trust ending within the fiscal or calendar year upon the basis of which such beneficiary's net income is computed. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

This section evidently contemplates two situations (A) where the tax is paid by the fiduciary (classes 1, 2, and 3) and (B) where the tax is paid by the beneficiaries; and (with one exception) assumes that every estate or trust will be classified *in toto* in one of those groups. It, therefore, treats each estate or trust as a unit and subject to but one mode of procedure. It reiterates the phrase "the net income of the estate or trust" and grants class (A) the same credits allowed to a single person [subdivision (c)] and the class (B) in the aggregate the credits specified in subdivisions (a) and (b) of section 216 [subdivision (d)].

The exception referred to is that estates during the period of administration (tax payable by the fiduciary) may deduct amounts of income "properly paid or credited to any legatee, heir, or other beneficiary," and the tax upon such amounts must be paid by the beneficiary. Here a double classification is contemplated by the statute. The natural reading of subdivision (c) indicates that in such case the estate is allowed all of the credits and the distributees none. With this single exception the statute contemplates that each estate or trust may be classed as one, the tax upon the entire income of which is payable by the beneficiaries, or one, the tax upon the entire income of which is payable by the fiduciary. No one of the cases stated above, however, is susceptible of such simple treatment. Difficulties in the application of the language of the section to such cases therefore arise, and that language must be construed to adapt the spirit and intent of the section to cases not specifically contemplated or provided for by its terms.

I. Where part of the income is to be distributed and part to be held for future distribution or added to the corpus.

This question was passed upon in Solicitor's Memorandum 488 under the Act of October 3, 1913. It was there held that the amounts not distributed should be accounted for by the fiduciary. That statute, however, differed from the Revenue Act of 1918.

The present statute specifies class (3) "Income held for future distribution under the terms of the will or trust" and class (4) "Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals * * *." It seems clear that the part of the income which is distributable falls within class (4) and that the part which is accumulated falls within class (3). It is clear that the total amount in question is *income* for which some one should account, and that it would be highly inequitable and unjust to tax the present beneficiary upon income which is not distributable to him and to which he is not beneficially entitled. It is equitable and just, however, that the fiduciary should pay the tax upon income accumulated for the benefit of the remaindermen, thereby deducting the tax from the amount to be distributed to the remaindermen in the future. It is therefore evident that in this case the two classes of income must be treated differently in spite of the general treatment of estates and trusts as a unit by the statute. It is held that when part of the income is accumulated for future distribution and part is distributable periodically that (a) the income which is accumulated for future distribution must be reported by the fiduciary and any tax on account of such income must be paid by the fiduciary as provided in section 219(c); (b) the income which is distributable periodically must be accounted for by the beneficiaries as provided in subdivision (d) of section 219; (c) this can best be accomplished by the filing of a return by the fiduciary on Form 1041 in the ordinary manner, showing the net income of the estate or trust computed as a unit. In filling out question 7, page 1, showing the distribution of income, the amounts to which the beneficiaries are entitled (whether distributed or not) should be shown. The aggregate distributive shares of the beneficiaries may be more or less than the net income of the estate or trust computed as a unit. The beneficiaries should include in their returns as individuals the distributive shares so reported by the fiduciary. If the net income of the estate or trust exceeds the aggregate distributive shares of the individual beneficiaries, such excess should be shown on Form 1041 as the distributive share of the fiduciary and if such amount exceeds $1,000 a separate report should be made on Form 1040 or 1040–A by the fiduciary including such income.

II. Items of gross income (according to income tax statute) which are considered capital by the probate courts and are not distributed to the life beneficiaries, but are added to the corpus, e. g., gains from sale of capital assets, stock dividends.

This question was passed upon in Law Opinion 1012. This differs from case (I) only in the fact that the probate courts do not agree that the items here in question are *income*. As to this, however, the Federal statute and not the rule of probate law must govern. Decisions as to income and capital in other fields of law are not necessarily followed for income tax purposes. *Trefry* v. *Putnam*, Mass. 1917, 116 N. E. 934. The decisions of the local courts, however, as to the distribution of such items of income are important. They determine by whom the income should be accounted for. This makes

it necessary that the distributable income be treated under class (4) and the capital gain or stock dividend under class (3) of section 219(a). The rules stated in answer to case (I) therefore apply.

III. Items of deduction (according to income tax statute) which are considered capital deductions by the probate courts and are deducted from the corpus and not from the distributable income, i. e., loss from the sale of capital assets.

On this question conflicting decisions are found. Law Opinion 770 (March 13, 1919) holds that the beneficiaries are not entitled to deduct from their distributive shares losses from the sale of capital assets. Advisory Tax Board Recommendation 56 (September 2, 1919) holds, in effect, that the beneficiaries are entitled to deduct from their distributive shares the losses due to the sale of capital assets. The latter ruling is based on the theory that the aggregate distributive shares of the beneficiaries can not exceed the net income of the estate or trust, because section 219 contemplated a computation of the net income of the estate or trust as a unit and for an accounting by the beneficiaries of their distributive share of such net income so computed. This applies a literal interpretation of the statute, but reaches a result which should be avoided if possible, since it is contrary to the fundamental rights of the parties and to the spirit and purpose of income taxation in general. As stated in Law Opinion 770:

> In the instant case the person receiving the income does not sustain the loss sought to be deducted. It is a loss of capital sustained by the remainderman. The trustee would have no right to deduct the amount of this loss from current income in making distribution to the beneficiaries.

Not only does such deduction benefit the life tenant who is not equitably entitled to deduct the loss, but it injures the remainderman, even if there is no capital gain in that taxable year to offset the capital loss. Trustees may be induced to make such sales in order to register a loss for the benefit of the life tenant. The remainderman is thus prevented from registering the loss at a later date when his remainder becomes vested in possession, and may be compelled to account for an unduly large gain at some time in the future.

But for this statutory difficulty it would seem obvious that the rule applied in solving cases (I) and (II) should apply here and that we should recognize that an estate or trust is not a unit but an aggregate of different and often conflicting interests, to all of whom the fiduciaries are responsible. If a single trust provided that income from stock X should be paid to A for life and income from stock Y to B for life, the remainder in both to C, it would scarcely be contended that B's distributive share should be reduced because the income from stock X was less than the expenses attributable thereto. Yet in such case B's distributive share would be more than the net income of the trust computed as a unit. A similar conflict of interests exists between life tenant and remainderman and must be recognized in interpreting the statute to avoid an inequitable and unreasonable result. The net income of the estate or trust is the result of statutory deductions from statutory gross income. In case the estate or trust comprises different interests the various items of income and deduction should be scrutinized and allocated so far as possible to the proper interest. By this means a life tenant receiv-

ing income will be required to account for all amounts received by him as income (except exempt income), even though the aggregate of distributive shares so determined exceeds the net income of the estate or trust computed as a unit. The principles stated with reference to case (I) apply here. The beneficiaries are not therefore entitled to account for less than the actual distributions of income to them by reason of capital losses which do not reduce the distributable income. The statutory language treating the estate or trust as a unit must be regarded as applying to that part of the estate which is properly treated as a unit. The procedure here adopted carries out the general purpose and intent of the section.

IV. Items of deduction (according to income tax statute) which are disregarded by the State courts in making distributions, there being no term of the will or trust or rule of law requiring their deduction from distributable income, e. g., depreciation and depletion.

In Law Opinion 456 it was held, under the Revenue Act of 1916 as amended, that the beneficiaries should compute their distributive shares after deduction of depletion. That statute, however, differed from the present one. In Advisory Tax Board Recommendation 56 a similar ruling was made with reference to depreciation under the Revenue Act of 1918.

These rulings were based upon the literal interpretation of the statute previously discussed and upon the theory that where a will provided for the distribution of income without deduction for depreciation or depletion the beneficiary really received partly income and partly capital. The line of reasoning developed in solving case (III), however, indicates that this result is erroneous. Deductions for depletion and depreciation are deductions designed to restore capital and as such affect the interest of the remainderman and do not affect the distributive share of the life tenant. Probate courts in general disregard depreciation (other than amounts actually expended for repairs) and depletion unless the trust specifically provides that deduction shall be made on that account. The sums received by the beneficiaries in such cases are clearly part of the gross income of the estate or trust and should not be reduced by deductions made to restore capital to which they are not entitled. The answer is the same as the answer to case (III).

V. Where there is a combination of these questions in one trust or estate.

The principal objection to the answers given to questions (III) and (IV) will be that the construction there adopted may deprive both life tenant and remainderman of the benefit of these deductions for the reason that there will be no income subject to the same treatment in some years from which to deduct them. It is obvious, however, that in many cases a part of the income will be accumulated for future distribution or part of the income will consist of gains from sale of capital assets so that such deduction may be taken. In such cases the equity of the classification of items of gross income and deductions adopted above is emphasized. Such cases will be readily solved by an application of the principles previously stated. The fact that a theoretically correct deduction is not beneficially deducted by anyone is a common occurrence and in no way decisive. The deduction is beneficially allowed if the same interest has a large

enough gross income. An individual who has no income loses the benefit of depreciation deductions to which he is entitled.

VI. This reasoning is not applicable where the estate or trust does not represent different interests and is susceptible of treatment as a unit. So property left in trust for an incompetent, or property left in trust in which the present beneficiary has the entire beneficial interest, could at least in cases (II), (III), and (IV) be treated as a unit and should be so treated. In case (I) the income accumulated for future distribution would be taxable to the fiduciary.

It is therefore held that under the Revenue Act of 1918 where an estate or trust represents different interests and is not susceptible of treatment as a unit the fiduciary, in determining the distributive shares of the beneficiaries, shall analyze the items of gross income and deduction and shall (a) account as fiduciary for income held for future distribution or added to the corpus; (b) assign to the beneficiaries income which is distributable periodically; (c) this can best be accomplished by the filing of a return by the fiduciary on Form 1041 in the ordinary manner, showing the net income of the estate or trust computed as a unit. In filling out question 7, page 1, showing the distribution of income, the amounts to which the beneficiaries are entitled (whether distributed or not) should be shown. The aggregate distributive shares of the beneficiaries may be more or less than the net income of the estate or trust computed as a unit. The beneficiaries should include in their returns as individuals the distributive shares so reported by the fiduciary. If the net income of the estate or trust exceeds the aggregate distributive shares of the individual beneficiaries such excess should be shown on Form 1041 as the distributive share of the fiduciary, and if such amount exceeds $1,000 a separate report should be made on Form 1040 or 1040–A by the fiduciary including such income.

The result of this will be that each beneficiary must include in computing his net income the entire sum which should be periodically distributed to him (whether distributed or not) from the estate or trust as income (other than exempt income) and no more than such sum.

SECTION 219, ARTICLE 347: Estates and trusts which can not be treated as a unit. 12–20–796 O. D. 413

T. D. 2987 revokes all previous rulings inconsistent therewith and is retroactive to January 1, 1918.

SECTION 220.—PROFITS OF CORPORATIONS TAXABLE TO STOCKHOLDERS.

SECTION 220, ARTICLE 351: Profits of corporation taxable to stockholders.

(See 2–20–667; sec. 201, art, 1542.) Application of section 220 in the case of a corporation which retires a portion of its capital stock without distributing its surplus.

SECTION 221.—PAYMENT OF TAX AT SOURCE.

SECTION 221, ARTICLE 361: Withholding tax at source. 12-20-797 O. D. 414

Where neither bonds nor the trust deeds given by the obligor to secure them contain a tax-free covenant, supplemental agreements executed by the obligor corporation and the trustee containing a tax-free covenant and which modify the original trust deeds to that extent are of the same effect from the date of their proper execution as if they had been part of the original deeds of trust, and the bonds from such date are subject to the provisions of section 221(b) of the Revenue Act of 1918, provided proper authority exists for the modification of the trust deeds in this manner. The authority must be contained in the original trust deeds or actually secured from the bondholders.

SECTION 221, ARTICLE 361: Withholding tax at source. 15-20-852 O. D. 455

A domestic corporation owning no property and doing no business in the United States issued bonds containing a covenant to pay the interest without deduction for any taxes under any law of the United States, any of its possessions, or of a foreign country. Under such circumstances the corporation is not absolved from the withholding requirements of section 221(b) of the Revenue Act of 1918 in the case of bondholders who are citizens or residents of the United States. The situation is not analogous to that of interest from nonresident corporations paid to nonresident alien individuals. Such income is not taxable gross income and need not be reported by the nonresident alien individual. Such interest, however, paid to citizens and residents of the United States is taxable gross income, must be reported by the taxpayer, and a tax upon such income is due the United States. No exception as to withholding requirements may be made even though the amount of tax withheld and paid to the United States possession or foreign country is claimed by the bondholder as a credit against his income tax liability to the United States Government under the provisions of section 222 of the 1918 Act.

SECTION 221, ARTICLE 361: Withholding tax at source. 21-20-955 O. D. 517

(Also Section 213(c), Article 91.)

The M Company is a corporation which was organized in the United States, but its principal assets are located in a foreign country. The accounts of the corporation were kept abroad until 1915 when its affairs were placed in the hands of receivers appointed by a United States court. Since that time the receivers have conducted the business for the benefit of the bondholders on whose behalf they were appointed, but upon the liquidation of the overdue interest upon its mortgages the corporation will be reinstated as an operating company. The corporation owns property in this country which it has pledged as part security for its mortgages;

it maintains an office in the United States for convenience in making purchases of goods to be shipped to the country in which it operates; its funds are on deposit in domestic banks. In addition, the receivers have an office in this country where they conduct the affairs of the corporation.

Held, that the company is not only a corporation organized under the laws of the United States, but is also a resident of the United States, actually and substantially carrying on business therein. Consequently, interest paid on its tax-free covenant bonds to nonresident aliens is income from sources within the United States within the meaning of section 213(c) of the Revenue Act of 1918, and is subject to withholding at the source at the rate of 2 per cent in accordance with section 221(b) of that Act.

SECTION 221, ARTICLE 361: Withholding tax at source. 21–20–956 O. D. 518

"Withholding at the highest applicable rate" as provided in article 361 of Regulations 45, in the case of interest on bonds or other securities where the owner is unknown to the withholding agent is interpreted to mean the highest rate of tax applicable under section 221 of the Revenue Act of 1918, viz, 2 per cent in the case of tax-free bonds and 8 per cent in the case of other fixed or determinable annual or periodical income.

SECTION 221, ARTICLE 361: Withholding tax at source. 21–20–957 O. D. 519

The Revenue Act of 1918 provides for withholding of 2 per cent of the interest on tax-free covenant bonds only when such bonds are the obligation of a corporation. Withholding is therefore not required on the interest on tax-free covenant bonds, when the obligor is other than a corporation.

SECTION 221, ARTICLE 361: Withholding tax at source. 26–20–1030 O. D. 561

The term "corporation" as used in section 221(b) of the Revenue Act of 1918 is construed to include foreign, domestic, and resident corporations.

Where a foreign corporation has a fiscal agent or paying agent in this country such agent is required to withhold the normal tax of 2 per cent upon the interest derived from its tax-free covenant bonds in the following instances:

When the owner of the bonds is a citizen or resident of the United States who does not wish to claim exemption from having tax paid at the source on such interest;

When the owner of the bonds is a domestic partnership or a personal service corporation;

When the coupons are presented unaccompanied by an ownership certificate.

The fiscal agent or paying agent is required to file monthly returns, Form 1012, revised, accompanied by the ownership certificates re-

ceived, and annual returns, Form 1013, revised, both forms modified to show its name and address as the agent of the debtor corporation concerned.

SECTION 221, ARTICLE 362: Fixed or determinable annual or periodical income.

(See 4–20–708; sec. 233, art. 550.) Share of profits realized by a foreign corporation on sales of its merchandise made in the United States by a domestic corporation.

SECTION 221, ARTICLE 362: Fixed or determinable annual or periodical income. (Also Section 237, Article 601.) 16–20–865 O. 1024

INCOME TAX: TITLE II, SECTIONS 221(a) AND 237, OF THE REVENUE ACT OF 1918.

Discount on Acceptances—Withholdings.

(1) The excess of the face value of a so-called bank acceptance as collected at its maturity over the amount paid therefor by a person collecting the acceptance at maturity is not interest within the meaning of sections 221(a) and 237 of the taxing Act.

(2) Gains and profits derived from the purchase and sale of so-called bank acceptances are not fixed or determinable annual or periodical income within the meaning of sections 221(a) and 237 of the taxing Act, and are not subject to the withholding provisions of the Act.

Opinion is requested as to whether income derived by a foreign corporation through buying and selling bank acceptances in this country represents income from sources within the United States which is subject to the withholding provisions of the taxing Act.

Section 221(a) of the Revenue Act of 1918 provides:

That all individuals, corporations, and partnerships, in whatever capacity acting, * * * having the control, receipt, 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 * * * shall * * * deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 8 per centum thereof; * * *.

Section 237 of the Act provides:

That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 10 per centum thereof, and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section * * *.

The M Company, a domestic corporation, purchases and sells in this country bank acceptances so-called on behalf of certain foreign corporations not engaged in trade or business within the United States and having no office or place of business therein. It seeks information as to whether at the maturity or sale of such acceptances

it is responsible for the deduction and withholding of the 10 per cent tax on the amount of the discount. It is contended:

(a) That an acceptance is discounted when sold, but in subsequent transactions between the period of sale and the period of maturity the market price of such an acceptance fluctuates in the same manner, although within closer limits, as the market price of a high-grade bond. The difference between an acceptance and a bond, however, is that, while the market price of the bond may fluctuate from time to time, there is no fluctuation in the rate of interest, the coupon rate or interest rate being fixed and determinable and a specific amount being collected from time to time as the interest matures.

(b) That where acceptances are purchased on behalf of a foreign corporation and subsequently sold, there my be a profit or a loss on the transaction. There is no fixed and determinable rate of income received by the foreign corporation on whose behalf the transaction is made. If an acceptance is purchased on behalf of a corporation and held until maturity, there would be at the time of purchase a definite amount of profit or income, which would accrue to the purchaser, but this is the only case in which it seems that there is any fixed or determinable, though not annual or periodical, income or profit. If, however, a foreign corporation transmits acceptances to a domestic corporation to be held and collected at maturity, there is absolutely no means of determining what the profit on such a transaction is; and, also, where on behalf of a foreign corporation acceptances are purchased and sold prior to maturity, there is no fixed or determinable profit or income accruing to such corporation.

The ordinary bank acceptance does not bear interest. An individual, or corporation of known financial standing, issues his promissory note for a given amount payable in from 60 to 90 days. This is sold by the maker. If it were a 90-day note and the prevailing discount rate were 6 per cent it would, of course, be sold at a discount of 1½ per cent. The purchaser might hold it for only a few days and sell it at a profit if the rate of discount at that time had dropped to say, 5½ per cent. If, on the other hand, the discount rate had advanced to 6½ per cent, he might sell it at a loss.

(1) Discount is a compensation for the use of money and as such resembles interest. But it has many features which distinguish it from interest. Interest is usually payable annually or at shorter periods before the maturity of the obligation. Discount is never paid by the obligor until the maturity of the obligation. A bank which loans money on a noninterest-bearing note payable in the future receives upon the payment of the note "discount." Such discount is not "interest" and is not, therefore, subject to the withholding provisions of sections 221(a) and 237 of the Revenue Act of 1918. Where a trust company purchases acceptances for a foreign corporation, the foreign corporation is required to make a return of income derived from such transactions and pay the tax shown to be due by such return.

(2) Since discount is not to be regarded as interest or as a fixed or determinable annual or periodical income within the meaning of the taxing Act, a trust company purchasing and selling acceptances for a foreign corporation and making a profit for the foreign corporation from such transactions is not required to withhold income tax upon

the profits realized. The foreign corporation is required to account for the gains and profits made on such transactions the same as is indicated in the preceding paragraph.

SECTION 221, ARTICLE 362: Fixed or determinable annual or periodical income. (Also Section 237, Article 601.) — 24-20-1007 O. D. 459

Interest on call loans made by a domestic bank for the account of a foreign bank is subject to withholding under section 221(a) of the Revenue Act of 1918. While the actual amount of interest may vary daily on account of the fluctuation of the principal, the rate of interest is fixed and the amount of interest is therefore determinable. The total amount of interest credited to the account of the foreign bank during the calendar year is the amount subject to withholding.

SECTION 221, ARTICLE 364: Ownership certificates for interest coupons. — 5-20-719 O. D. 392

In the case of interest payments on overdue coupon bonds, the interest coupons of which have been exhausted, ownership certificates are required to be filed when collecting the interest in the same manner as if interest coupons were presented for collection.

SECTION 221, ARTICLE 364: Ownership certificates for interest coupons. (Also Section 256, Article 1078.) — 21-20-958 O. D. 520

The following is a schedule of ownership certificates to be used when collecting income derived from the various classes of securities:

Classification of owner.	Domestic or resident corporations.	
	Containing tax-free clause.	Not containing tax-free clause.
Citizen or resident of the United States (individual or fiduciary) *not claiming exemption.*	Form 1000, line 1	Form 1001, line 2.
Citizen or resident of the United States (individual or fiduciary) *when exemption is claimed.*	Form 1001, line 1	Form 1001, line 2.
Domestic or resident partnership or personal service corporation.	Form 1000, line 2	Form 1001, line 3.
Domestic or resident corporation	Form 1001, line 4	Form 1001, line 4.
Nonresident alien (individual or fiduciary)	Form 1000, line 3	Form 1000, line 3.
Nonresident alien partnership	Form 1000, line 4	Form 1001, line 5.
Foreign corporation *not having* an office or place of business in the United States.	Form 1000, line 5	Form 1000, line 5.
Foreign corporation *having* an office or place of business in the United States.	Form 1001, line 6	Form 1001, line 6.
Foreign government	Form 1001, line 7	Form 1001, line 7.
Unknown owner	Form 1000, line 6	Form 1000, line 6.

When a foreign corporation or a foreign Government has issued bonds containing a tax-free covenant clause, and the debtor organi-

zation has a paying agent in the United States, while the interest derived from such bonds is not subject to tax when the bonds are owned by nonresident alien individuals, fiduciaries, partnerships, or corporations having no office or place of business in the United States, the normal tax of 2 per cent is payable at the source on such interest in certain instances, as will be seen by the following schedule:

Classification of owner.	Bonds of foreign corporations or foreign governments.		
	Containing tax-free clause and having paying agent in United States.	Not containing tax-free clause and whether or not having paying agent in United States.	Stocks of foreign corporations.
Citizen or resident of the United States (individual or fiduciary) *not claiming exemption.*	Form 1000, line 1.....	Form 1001–A, line 1..	Form 1001–A, line 1.
Domestic or resident partnerships or personal service corporations.	Form 1000, line 2.....	Form 1001–A, line 2..	Form 1001–A, line 2.
Unknown owner.....	Form 1000, line 6.....	Form 1001–A.....	Form 1001–A.
Citizen or resident of United States (individual or fiduciary) *when exemption is claimed.*	Form 1001–A, line 1..	Form 1001–A, line 1..	Form 1001–A, line 1.
Domestic or resident corporations...	Form 1001–A, line 3..	Form 1001–A, line 3..	Form 1001–A, line 3.
Nonresident alien individuals or fiduciaries.	Form 1001–A, line 4..	Form 1001–A, line 4..	Form 1001–A, line 4.
Nonresident alien partnerships.....	Form 1001–A, line 5..	Form 1001–A, line 5..	Form 1001–A, line 5.
Nonresident alien corporations.....	Form 1001–A, line 6..	Form 1001–A, line 6..	Form 1001–A, line 6.

Income payable to a foreign government is not subject to Federal tax, but should be reported on line 6 of Form 1001–A, crossing out the word "corporation" and substituting therefor "foreign government." With respect to foreign items presented for collection unaccompanied by an ownership certificate, if the item is a coupon detached from a bond containing a tax-free covenant clause and the debtor organization has a paying agent in the United States, line 6 of Form 1000 is the proper place for reporting such income.

SECTION 221, ARTICLE 364: Ownership certificates for interest coupons. 26–20–1031 O. D. 562

Banks or other collecting agents receiving coupons attached to ownership certificates executed on the wrong form, in order to expedite the collection of the interest, are permitted to transfer the necessary information from the erroneous to the proper form, the following notations being stamped in the lower left-hand corner:

"_____
(Name and address of bank or collecting agent.)
By_____"
(Name of official executing certificate.)

The original certificate should be forwarded with the certificate executed on the proper form by the bank or collecting agent, the original certificate bearing the notation substantially as follows: "Superseded by ownership certificate Form _____," designating the form of certificate executed by the bank or collecting agent.

SECTION 221, ARTICLE 364: Ownership certificates for interest coupons. 26–20–1032 O. D. 563
(Also Section 213(a), Article 31.)

A corporation which defaulted in the payment of its bond interest was reorganized, and the new corporation issued scrip, payable at certain fixed dates and bearing interest at 6 per cent, in exchange for the coupons representing the defaulted interest.

Inasmuch as scrip issued in payment of interest on bonds is equivalent to cash, it is subject to the withholding provisions of the Revenue Act of 1918. Ownership certificates are required to be filed by the owners when exchanging their coupons for scrip, covering the face value of the coupons so exchanged, the form of certificate depending upon whether or not the bonds are tax-free and whether or not the owner claims exemption from having tax paid at the source.

The withholding requirements of the law are not applicable to the 6 per cent interest paid by the terms of the scrip on the defaulted bond interest, unless the scrip is held by nonresident aliens, in which case the normal tax of 8 per cent or 10 per cent is required to be withheld, dependent upon whether such holder is a nonresident alien individual or a nonresident alien corporation.

SECTION 221, ARTICLE 367: Use of substitute certificates. 6–20–732 T. D. 2967

Regulations 45 are amended by changing article 367 to read as follows:

ART. 367. *Use of substitute certificates.*—Resident collecting agents and responsible banks and bankers, receiving interest coupons for collection with ownership certificates attached, may present the coupons with the original certificates to the debtor corporation or his duly authorized withholding agent for collection or may detach and forward the original certificates directly to the Commissioner, provided each such collecting agent shall substitute for such original certificates its own certificates, Form 1058, revised, or Form 1059, revised, and shall keep a complete record of each transaction, showing (a) serial number of item received; (b) date received; (c) name and address of person from whom received; (d) name of debtor corporation; (e) class of bonds from which coupons were cut (whether containing a tax-free covenant or not); and (f) face amount of coupons. The original certificate for which the certificate of the collecting agent is substituted shall be indorsed, preferably with a rubber stamp, by the collecting agent as follows:

OWNER'S CERTIFICATE NO._____

_____
(Name of collecting agent.)

_____ 19____
(Give date of certificate.)

The counterpart of the within certificate bearing like number was attached to the coupons within mentioned for delivery to the debtor or withholding agent, by whom the coupons are payable.

For the purpose of identification the substitute certificates shall be numbered consecutively, reverting to the numeral 1 at the beginning of each calendar year, and corresponding numbers given the original certificates of ownership. The use of substitute certificates by collecting agents, banks, and bankers is not permitted, however, in the case of ownership certificates presented with coupons for collection by nonresident alien individuals, partnerships, or corporations.

SECTION 221, ARTICLE 368: Interest coupons without ownership certificates. 22-20-973 T. D. 3018

Regulations 45 are amended by changing article 368 to read as follows:

ART. 368. *Interest coupons without ownership certificates.*—When interest coupons are received unaccompanied by certificates of ownership, the first bank shall require of the payee an affidavit showing the name and address of the payee, the name and address of the debtor corporation, the date of the maturity of the interest, the name and address of the person from whom the coupons were received, the amount of the interest, and a statement that the owner of the bonds is unknown to the payee. Such affidavit shall be forwarded to the collector with the monthly return on Form 1012, revised. The first bank receiving such coupons shall also prepare a certificate on Form 1000, revised, crossing out "owner" and inserting "payee" and entering the amount of interest on line 6, and shall stamp or write across the face of the certificate "Affidavit furnished," adding the name of the bank.

SECTION 221, ARTICLE 373: Use of information return where no actual withholding. 18-20-901 O. 1025

ADMINISTRATIVE: FRANKING OF CORPORATION OWNERSHIP CERTIFICATES.

The Acting Third Assistant Postmaster General, who is the administrative officer of the Post Office Department having charge of such matters, holds that it is not permissible, under the law governing the use of penalty envelopes, for the Commissioner of Internal Revenue to furnish such envelopes to debtor corporations or their withholding agents to enable them to transmit in the mails free of postage to the Commissioner exemption ownership certificates. Accordingly Law Opinion 971 is overruled.

On December 2, 1919, Law Opinion 971 was issued holding that the Commissioner of Internal Revenue has authority, under the Act of March 3, 1877, and the Act of March 3, 1879, as amended by the Act of July 5, 1884, to furnish return penalty envelopes to withholding agents who have required of persons presenting interest coupons for payment exemption certificates on Forms 1001, revised, such return penalty envelopes to be used by them in transmitting to the Commissioner such certificates. Later the matter was presented to the Solicitor of the Treasury Department, who stated, on January 10, 1920, that he concurred in the opinion, but suggested that the matter be referred to the Third Assistant Postmaster General with the request that he pass on the question. On January 20, 1920, the Acting Third Assistant Postmaster General was requested to pass upon the question, and on February 27, 1920, he, after citing the applicable statutes, including the one embodied in section 496, Postal Laws and Regulations, states his conclusion as follows:

It is not permissible, therefore, under the laws governing the use of penalty envelopes for the Commissioner of Internal Revenue to furnish such envelopes to debtor corporations or their withholding agents to enable them to transmit in the mails free of postage to the Commissioner the ownership certificates described. Penalty envelopes improperly furnished to such debtor corporations or their withholding agents can not lawfully be used to send such ownership certificates in the mails free of postage.

In view of the conclusion reached by the Acting Third Assistant Postmaster General, the administrative officer of the Post Office Department charged with such matters, Law Opinion 971 holding to the contrary is overruled.

SECTION 221, ARTICLE 375: Withholding in the case of enemies. 7-20-742 T. D. 2969

Article 375, Treasury Department Regulations 45, is hereby amended to read as follows:

Payments made after October 6, 1917, to the Alien Property Custodian are in the same category as payments made to or for citizens or residents of the United States. Withholding at the source is accordingly unnecessary except in the case of interest payments on corporate bonds or other obligations containing a tax-free covenant where no exemption is claimed. The Alien Property Custodian should use Form 1000, revised, in collecting interest on bonds containing a tax-free covenant and in all other cases should use Form 1001, revised, except that in cases in which the Alien Property Custodian shall, under the Trading with the Enemy Act, demand payment to himself of interest accrued upon bonds or other securities not yet reduced to his custody (even though they be registered in the name of an enemy, ally of an enemy, or his agent or trustee), the corporation paying such income to the Alien Property Custodian is authorized to accept from the Alien Property Custodian ownership certificates, Forms 1000, revised, and 1001, revised, altered by the substitution (in lieu of the certificate required thereon) of a certificate that the Alien Property Custodian is entitled to the interest entered therein with or without deduction of tax, as the case may be. No distinction is to be made between payments directly to the Alien Property Custodian and to his depositaries and between interest on registered bonds and interest on coupon bonds. In the case of enemies or allies of enemies holding a license granted under the provisions of the Trading with the Enemy Act, withholding is required as in the case of any nonresident alien not an enemy or ally of enemy. See article 446.

SECTION 221, ARTICLE 376: Return of income from which tax withheld.

(See 8-20-758; sec. 250, art. 1004.) Assessment of ad valorem penalties in cases of delinquent and fraudulent returns rendered by withholding agents.

SECTION 221, ARTICLE 376: Return of income from which tax withheld. 13-20-812 O. D. 423

The amount of normal income tax paid at the source by a debtor corporation in behalf of a bondholder may be credited against the total tax due from the bondholder even though he may be liable to surtax only.

SECTION 222.—CREDIT FOR TAXES.

SECTION 222, ARTICLE 381: Analysis of credit for taxes.

(See 3-20-688; sec. 214(a) 3, art. 131.) Tax imposed by the Republic of Cuba on corporations operating sugar plantations in Cuba.

SECTION 222, ARTICLE 381: Analysis of credit for taxes. 5-20-720 O. D. 393

Alien residents of the United States who are citizens or subjects of Canada are entitled to credit against their tax liability to the United States, the amount of income, war profits, and excess profits taxes

paid to the Canadian Government on income from sources within Canada since the Canadian Government in imposing an income tax allows a similar credit to citizens of the United States residing in Canada.

SECTION 222, ARTICLE 381: Analysis of credit for taxes. 7-20-743 O. 987

INCOME TAX: SECTION 222, REVENUE ACT OF 1918.

Credits Allowed Citizens for Taxes Paid to Foreign Countries.

Any income, war profits or excess profits taxes paid by a citizen of the United States in 1918 to a foreign country, with respect to income received from sources therein, are an allowable credit under section 222(a) of the Revenue Act of 1918, against the amount of the tax due the United States for that year, provided the taxpayer's books of account are kept on a cash-receipt and payment basis and a return is rendered on that basis; if the taxpayer's books are kept on an accrual basis, and his returns are so rendered, the credit for taxes paid to a foreign country on income received from sources therein will be limited to taxes accrued in the taxable year for which the return is rendered.

The question has been asked as to whether income taxes due for the years 1916 and 1917, paid during 1918 to a foreign country, with respect to income derived from sources therein, by a citizen of the United States, are an allowable credit for the year in which paid.

Section 222(a) 1 of the Revenue Act of 1918 provides:

(a) That the tax computed under Part II of this title shall be credited with:
(1) In the case of a citizen of the United States, 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; * * *

The statute reads "taxes paid during the taxable year," but as pointed out by the Committee on Appeals and Review, section 200 of the Revenue Act of 1918, reads:

That when used in this title—
The term "paid" for the purpose of 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 212.

From this it is evident that the words are to be construed with reference to the method of accounting used by the taxpayer in computing his net income. If the taxpayer computes his net income upon a cash-receipt and payment basis there can be no allocation between years on any other basis than that of payment; that is, in computing net income for a particular year all payments properly chargeable against receipts are deductible in determining net income for that year. Thus if a taxpayer is keeping his books on a cash receipt and payment basis, renders his returns on that basis, and in 1918 pays taxes to a foreign country for 1916 and 1917 on income received from sources therein, the total amount of taxes paid in 1918 may be deducted from the amount of tax due the United States for that year. Under an accrual system, taxes paid for 1916 and 1917 in 1918 can not be credited; on an accrual system the credit will be

limited to the amount of income and profits taxes accrued in the taxable year for which the return is rendered. (See Solicitor's Memorandum 898. Compare Advisory Tax Board Recommendation 36 (p. 237, Cumulative Bulletin, December, 1919) with reference to the credit allowed for taxes paid to foreign countries under section 240(c) of Revenue Act of 1918.)

It is accordingly held that any income, war profits or excess profits taxes paid by a citizen of the United States in 1918 to a foreign country, with respect to income received from sources therein, are an allowance credit under Section 222(a) of the Revenue Act of 1918, against the amount of tax due the United States for that year, provided the taxpayer's books of account are kept on a cash-receipt and payment basis and a return is rendered on that basis; if the taxpayer's books are kept on an accrual basis, and his returns are so rendered, the credit for taxes paid to a foreign country on income received from sources therein will be limited to taxes accrued in the taxable year for which the return is rendered.

SECTION 222, ARTICLE 381: Analysis of credit for taxes. 13–20–813 O. D. 424

Alien residents of the United States who are citizens or subjects of the British colony of Jamaica are not entitled to credit against their tax liability to the United States the amount of income taxes paid to the government of Jamaica, since Jamaica in imposing an income tax does not allow a similar credit to citizens of the United States residing in that country.

SECTION 222, ARTICLE 381: Analysis of credit for taxes. 19–20–922 O. D. 499

Since Japan does not satisfy the similar credit requirements of section 222(a) 3 of the Revenue Act of 1918, a subject of Japan residing in the United States is not entitled to credit against his tax liability to the United States the amount of tax paid to Japan upon income derived from sources therein.

SECTION 222, ARTICLE 383: Conditions of allowance of credit. 26–20–1033 O. D. 564

Where a return is filed accompanied by a claim for credit for income and 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, the collector should forward the return to the Commissioner of Internal Revenue for audit, even though the credit claimed equals or exceeds the amount of tax as computed by the taxpayer. Such returns are not considered nontaxable for the purpose of retention in the collector's office.

SECTION 223.—INDIVIDUAL RETURNS.

SECTION 223, ARTICLE 401: Individual returns. 13–20–814
O. D. 425

An oral agreement whereby one of a number of brothers and sisters acts as agent for all of them in managing property held by them as tenants in common under the father's will, and in distributing the income therefrom, is not a legal trust for income tax purposes, nor is the agent a fiduciary. Each principal should file a separate return including therein his share of the income from the property and claiming a proportionate share of any allowable deductions.

SECTION 223, ARTICLE 401: Individual returns. 13–20–815
O. D. 426

COMMUNITY PROPERTY IN TEXAS AND WASHINGTON.

A husband and wife may not divide the salary of the husband or of the wife for the purpose of reporting such salary in separate returns for income tax purposes.

Under the laws of Texas and Washington property owned by the husband or wife prior to marriage remains the separate estate of the owner. Accordingly income, such as rents and interest from such property, should be reported by the husband or wife separately after marriage.

The legal owners of community property (property acquired after marriage) in the States of Texas and Washington are the husband and wife jointly in equal shares, and the income accruing therefrom is the joint income of the husband and wife in which each is entitled to one-half. Such income may therefore be divided for income tax purposes and the husband and wife may each report in separate returns one-half thereof. This is held to be true notwithstanding that in law the husband is given the right to manage and control community property the same as his separate estate and that as regards personal property he and he alone may dispose of it. (Ruling 21–19–528; sec. 223, art. 401, modified.) (See, however, T. D. 3071; 39–20–1218.

SECTION 223, ARTICLE 401: Individual returns.

(See 21–20–959; sec. 227, art. 444.) Extension of time to party filing joint return.

SECTION 223, ARTICLE 404: Return of income of nonresident alien.

(See 12–20–798; sec. 225, art. 425.) Liability of resident fiduciary for surtax on income received for nonresident alien beneficiary when return is made by the beneficiary. (Revenue Acts of 1916 and 1917.)

SECTION 225.—FIDUCIARY RETURNS.

SECTION 225, ARTICLE 421: Fiduciary returns.

(See 10–20–780; sec. 219, art. 345.) Duty of trustees to make returns upon all income from trust.

SECTION 225, ARTICLE 425: Return for nonresident alien beneficiary. 11–20–785 T. D. 2988.

REVENUE ACT OF 1917.

Paragraph 200 of article 29, Regulations 33, revised, is hereby amended to read as follows:

Nonresident alien beneficiary.—Where a fiduciary in the United States is the recipient of trust income for which there is but one beneficiary and that beneficiary a nonresident alien, the fiduciary will be required to make full and complete return on income tax Form 1040, or 1040A, as the case may be, for this trust income on behalf of the nonresident alien, and pay any and all normal tax found by such return to be due, and any and all surtax provided the income is not returned for the purpose of the tax by the beneficiary. Where there are two or more beneficiaries, one or all of whom are nonresident aliens, the fiduciary shall render a return on Form 1041, and a personal return on Form 1040 or 1040A, for each nonresident alien beneficiary.

SECTION 225, ARTICLE 425: Return for nonresident alien beneficiary. 12–20–798 O. 1011
(Also Section 223, Article 404.)

INCOME TAX: ASSESSMENT AND ADMINISTRATION—REVENUE ACT OF 1916, SECTION 9(b) AND (g), AS AMENDED BY REVENUE ACT OF 1917, SECTION 1205; REVENUE ACT OF 1916, SECTION 2(b).

A resident fiduciary is not liable for surtax on the income which it received as trustee for a nonresident alien beneficiary under the Revenue Act of 1917, provided the income was returned for the purpose of the tax by the beneficiary.

Opinion is requested as to whether the M Company, trustee for the nonresident alien, A, should be assessed the surtax due for the year 1917, upon income received by it during that year from sources within the United States for the benefit of said beneficiary.

Section 9(b), Revenue Act of 1916, as amended by section 1205, Revenue Act of 1917, provides as follows:

(b) All persons, corporations, partnerships, associations, and insurance companies, in whatever capacity acting, including lessees or mortgagors of real or personal property, trustees acting in any trust capacity, executors, administrators, receivers, conservators, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment of interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable annual or periodical gains, profits, and income of any nonresident alien individual, other than income derived from dividends on capital stock, or from the net earnings of a corporation, joint-stock company or association, or insurance company, which is taxable upon its net income as provided in this title, are hereby authorized and required to deduct and withhold from such annual or periodical gains, profits, and income such sum as will be sufficient to pay the *normal tax* imposed thereon by this

title, and shall make return thereof on or before March first of each year and, on or before the time fixed by law for the payment of the tax, shall pay the amount withheld to the officer of the United States Government authorized to receive the same; and they are each hereby made personally liable for such tax, and they are each hereby indemnified against every person, corporation, partnership, association, or insurance company, or demand whatsoever for all payments which they shall make in pursuance and by virtue of this title.

Section 9(g), Revenue Act of 1916, as amended by section 1205, Revenue Act of 1917, is, in part, as follows:

The provisions of this section, except subdivision (c) relating to the deduction and payment of the tax at the source of income, shall only apply to the normal tax hereinbefore imposed upon nonresident alien individuals.

Section 2(b), Revenue Act of 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 estate 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 trustee or other fiduciaries.

The M Company is trustee under the will of B. This will directs the trustee to pay the income, upon which the payment of the surtax is here under consideration, to A, a nonresident alien, residing in England. For the year 1917, the company filed an income tax return on Form 1040, as trustee for said beneficiary, in which the normal tax only was entered and paid. The question now presented is whether the trust company is also liable to pay the surtax due upon the income received by it as said trustee.

Regulations 33, revised, paragraph 200, provides as follows:

Where a fiduciary in the United States is the recipient of trust income for which there is but one beneficiary and that beneficiary a nonresident alien, the fiduciary will be required to make full and complete return on income tax Form 1040, or 1040–A, as the case may be, for this trust income on behalf of the nonresident alien and pay any and all tax found by such return to be due. Where there are two or more beneficiaries, one or all of whom are nonresident aliens, the fiduciary shall render a return on Form 1041, and a personal return on Form 1040, or 1040–A, for each nonresident alien beneficiary.

Under this regulation it would appear that the surtax in question could be assessed against the M Company regardless of whether the income had been returned for the purpose of the tax by the beneficiary. It is contended, however, that this regulation has no foundation in law in so far as it implies the right to assess the surtax against a resident fiduciary receiving income from sources within this country as trustee for a nonresident alien beneficiary.

The quotations from section 9, Revenue Act of 1916, as amended which are set forth above, show clearly that under that section a resident fiduciary is liable only for the normal tax on income which it receives for a nonresident alien beneficiary. (Regulations 33, revised, paragraph 258.) This section, however, relieving the fiduciary from liability for surtax, is qualified by section 2(b), Revenue Act of 1916, which applies to all trustees, and provides that income from any kind of property held in trust shall be subject to the normal and additional tax and taxed to the trustee " except when the income is returned for the purpose of the tax by the beneficiary."

Section 1005, Revenue Act of 1917, gives the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, authority to make needful rules and regulations for the enforcement of the provisions of the Act. Regulations of the department, however, have the force of law only where they do not conflict with any act of Congress. (*United States* v. *Ross*, 239 U. S. 530, 534; *United States* v. *Symonds*, 120 U. S., 46.) Clearly, if Regulations 33, revised, paragraph 200, is interpreted as holding a resident fiduciary liable for surtax on trust income received for a nonresident alien beneficiary when the income is returned for the purpose of the tax by the beneficiary, it conflicts directly with the provisions of section 9(b) and (g) Revenue Act of 1916, as amended by section 1205, Revenue Act of 1917, and with section 2(b), Revenue Act of 1916, and hence would have no legal force or effect.

It is, therefore, held that a resident fiduciary is not liable for surtax on the income which it received as trustee for a nonresident alien beneficiary under the Revenue Act of 1917, provided the income was returned for the purpose of the tax by the beneficiary.

SECTION 226.—RETURNS WHEN ACCOUNTING PERIOD CHANGED.

SECTION 226, ARTICLE 431: Returns when accounting period changed. 15–20–853 O. D. 456

An alien who arrived in the United States on September 1, 1919, and who actually keeps his books of account on a fiscal year basis ending August 31, is required to render a return on the basis of a fiscal year ending August 31.

Notice that he maintains an accounting period for the fiscal year ending August 31 should be given to the collector of internal revenue for the district in which the alien resides.

SECTION 226, ARTICLE 431: Returns when accounting period changed.

(See 24–20–996; sec. 212, art. 26.) Notice of change from fiscal to calendar year basis for filing returns.

SECTION 227.—TIME AND PLACE FOR FILING RETURN.

SECTION 227, ARTICLE 443: Extension of time by collector. 4-20-707 M. 2383

The acceptance of tentative returns and the use of forms 1040–T and 1031–T will not be permitted in the case of taxpayers filing returns for the calendar year 1919 or for a fiscal year ending in 1920 except in extraordinary cases on the specific authorization of the Commissioner. Any request for permission to file tentative returns in such cases should be addressed to the Commissioner and should state clearly the reasons why it is impossible to file complete returns on time. In cases of sickness or absence, collectors have authority to grant extensions of time not to exceed thirty days.

In meritorious cases collectors may extend the privilege of filing tentative income and profits tax returns on forms 1040–T and 1031–T to taxpayers reporting for a fiscal year ending prior to December 31, 1919, on condition that one-fourth the estimated tax is paid at the time of filing such returns. In these cases a reasonable extension of time for filing the completed returns will be granted by the Commissioner upon request of the taxpayers showing the reasons why completed returns could not be filed on time.

SECTION 227, ARTICLE 444: Extension of time by Commissioner. 11-20-789 M. 2420
(Also Section 241, Article 651.)

EXTENSION UNTIL MAY 15, 1920, OF THE FINAL DATE FOR FILING CORPORATION RETURNS, FORM 1120, FOR THE CALENDAR YEAR 1919.

In view of the fact that considerable difficulty is being experienced by corporations and their representatives in the preparation of income tax returns for the year 1919, collectors of internal revenue are hereby authorized to accept tentative corporation returns for the calendar year 1919 on or before March 15, 1920. Each return must be accompanied by at least one-fourth of the estimated amount of tax due, together with a statement setting forth the reason why the return can not be completed within the prescribed time, *and a formal request for the extension.* Any deficiency in the first installment will bear interest at the rate of 6 per cent per annum.

An extension of time is hereby granted to corporations in such cases to file completed returns on or before May 15, 1920. The tentative return submitted in accordance with the foregoing should be on Form 1120, on which should be written plainly across the face "Tentative return." Only the estimated amount of tax due need be stated.

Tentative returns filed under this authority will be handled in collectors' offices in the manner prescribed for the handling of similar returns last year.

A further extension of time within which to file returns will not be granted except in extraordinary cases and upon proper application to the Commissioner of Internal Revenue, setting forth the reasons why the return can not be completed.

I. T. Mim. 2383 is modified accordingly.

SECTION 227, ARTICLE 444: Extension of time by Com aissioner. (Also Section 223, Article 401.) 21-20-959 O. D. 521

Where a husband and wife file a joint return and an extension of time has been granted to either of them, the benefit of the extension inures to both and it will be unnecessary for the other party to secure additional authority.

SECTION 227, ARTICLE 445: Extension of time in the case of persons abroad. 14-20-839 O. D. 443

Article 445, Regulations 45 (art. 443 in preliminary edition) granting an extension of time for filing returns for 1918 and subsequent years in cases of persons abroad is held to apply also to domestic corporations transacting their business and keeping their records and books of account abroad.

PART III.—CORPORATIONS.

SECTION 230.—TAX ON CORPORATIONS.

SECTION 230, ARTICLE 503: Corporations liable to tax. (Also Section 233, Article 545.) 19-20-928 S. 1385

CORPORATION INCOME TAX, REVENUE ACT OF 1918. (SECTIONS 230(a), 233(a), 232, AND 213.)

Concerning the character of return to be filed and the accounting in such return for profits derived from the sale of capital assets by the M Company and four other Texas joint-stock companies.

A change of form from that of a corporation or association to that of a trust or partnership accompanied by a transfer of capital assets to trustees for the benefit of shareholders followed by a sale of such assets at a price in excess of the cost thereof to the corporation or association, and the distribution of proceeds to the beneficiaries (shareholders), such change being made for the main purpose of avoiding the tax which would accrue to the corporation had the sale been made by it, should be disregarded as a mere sham to avoid assessment of tax against the corporation or association upon the profit derived from such sale, and the corporation or association should be required to return as income any profit derived as though the sale had been made by it directly.

The question is presented as to the character of return to be filed and the accountability for gain derived from the sale of capital assets in the case of the M Company, the N Company, the O Company, the P Company, and the Q Association, which, during the year 1919, conveyed all their assets to trustees for the benefit of their shareholders (in the case of the three first named) or to trustees holding for a partnership (in the case of the two last named).

The M Company and the N and O Companies were organized as joint-stock associations under the Texas laws in the usual form dur-

ing the year 1918. In each case the purpose of the organization was to carry on the business of producing oil. Each association had a small number of shareholders who contributed capital, which capital was used for the purpose of acquiring oil leases and other property. During the latter part of 1919, after these leases and other properties had appreciated greatly in value these associations desired to dissolve and distribute their assets to their shareholders. Realizing (and this is admitted by the attorneys for the parties) that if the assets were sold while in the possession of the associations a large profit would have to be returned by the associations as taxable income, the persons interested created "trusts" in the usual Massachusetts or common law form, to which trusts were assigned and conveyed all of such assets for the purpose of being administered and sold, if occasion were afforded, for the benefit of the former shareholders who held beneficial interest in proportion to their former holdings of stock. In each case, and within one month after being assigned, the entire assets were in fact sold by the trustees and the proceeds thereof distributed to the beneficiaries.

In the case of the P Company and the Q Association the same facts are presented, except that the device adopted was the change of form from an association to a partnership. This was done by a resolution of shareholders dissolving the association and authorizing the transfer of all assets to the same persons who held title for the company to hold from that time as trustees for the individual partners. In those cases the sale by the trustees, acting in their new capacities, took place the day following the adoption of the resolutions dissolving the associations and authorizing the transfer of assets. In the case of the Q Association it appears that although the business was conducted under the name and in the form of an association with outstanding shares of capital stock, no articles of association or declaration of trust had ever actually been executed.

The applicable provisions of the Revenue Act of 1918 are as follows:

SEC. 230(a). That, in lieu of the taxes imposed by section 10 of the Revenue Act of 1916, as amended by the Revenue Act of 1917, and by section 4 of the Revenue Act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates: * * *.

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

SEC. 233(a). That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in section 213, except that: * * *.

SEC. 213. That for the purpose of this title (except as otherwise provided in sec. 233) the term "gross income"—

(a) Includes gains, profits, and income derived from * * * commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; * * *.

Under the Revenue Act of 1918 the term "corporation" is defined to include associations and joint-stock companies. There is no question raised that all of the associations under discussion are required to file returns of income as "corporations" up to the time of dissolution and transfer of assets to trustees. This is true even in the case

of the Q Association, which was apparently organized without the formal signing of articles of association and agreement of trust.

Voluntary unincorporated associations are recognized by the Texas law. They are usually composed of a number of persons whose interests are evidenced by certificates of stock and whose business affairs are transacted through named trustees with prescribed powers, which trustees hold *the legal* title to the property of the associations. (*Clark* v. *Brown* (Tex.), 108 S. W. 421, 433; *Industrial Lumber Co.* v. *Texas Pine Land Association*, 72 S. W. 875.) Such associations are not formed under any provision of statutory law, as are corporations, but simply by agreement among the persons. The law of Texas does, however, provide that suits may be instituted or defended in the company name. (See Vernon's Sayles' Texas Civil Statutes, 1914, arts. 6149 to 6154.)

No method is prescribed in the Texas statutes for the dissolution of such associations. Presumably they may dissolve in the same way they are formed, namely, by agreement among the parties. The Texas statutes, however, recognize a business status known as limited partnerships, requirements for the creation of which are found in the same title of the above-mentioned Texas Civil Statutes as the provisions permitting suit in the company name by unincorporated associations. With respect to limited partnerships it is provided (art. 6148) that no dissolution by acts of the parties shall take place previous to the time specified in the certificate of its formation unless notice of such dissolution shall have been filed and recorded and published once in each week for four weeks in a newspaper. It is not clear under the Texas law whether the same requirement of publication is necessary in the case of dissolution of unincorporated joint-stock companies. For the purpose of this memorandum it may be granted that the dissolution in each case was regular and proper, so far as Texas statutory law is concerned.

In the cases under consideration all of the shareholders and interested parties agreed to the transfer of the assets, and to the dissolution of the companies by appropriate resolutions. Pursuant to the terms of such resolutions the trustees who held the legal title to the property of the associations transferred and assigned the same either to themselves or to some of them as trustees for the shareholders—

> In trust to convert the same into money and distribute the net proceeds thereof among the persons at the time of such conversion holding and owning the beneficial interests therein, as evidenced by the receipt certificates issued by the trustees as hereinafter provided. (See attorney's brief, p. 58.)

It is admitted in the brief filed on behalf of the taxpayers that the sole purpose of the creation of the trusts and the transfer of assets to the trustees was that "the income and excess profits tax, which would otherwise fall upon the company, would be avoided." (Brief, pp. 4, 7, 10, 13, 16.) In each case the trustees to whom the assets were transferred were among the principal stockholders, members of the board of trustees, and officers of the associations. (Brief, pp. 2, 6, 8.) In each case the dissolution was effected contemporaneously with the transfer of assets to the trustees. While there is some doubt as to whether arrangements had actually been made for the sale of the properties at the time of dissolution and transfer (except as to the P Company and the Q Association, in which it is admitted contracts

of sale had already been entered into—see brief, pp. 12, 15) there is no doubt that at such time the parties in interest contemplated an advantageous sale in the near future. (Brief, p. 4.)

As a general principle, it may be stated that where the effect of a transaction is to avoid the payment of tax the courts will—

> Look beyond the surface facts and inquire into the real nature of the transaction in question, that it may be dealt with as it is in fact, and not as it has for improper purposes been made to appear. *People* v. *Albany Gas. Co.*, 92 N. Y. 458.

Thus it was held in a case arising in Kansas that—

> Whether a resolution of the directors of a national bank declaring a dividend payable out of the surplus to be placed to the stockholders' credit, and to remain as a deposit until otherwise ordered, was made in good faith or was a mere subterfuge to avoid taxation, was a question of fact to be determined by the trial court. *Pollard* v. *First National Bank*, 47 Kansas, 406.

It may be conceded that under our laws an individual or group of individuals may do business under any legal forms they see fit, viz, the corporate, the joint-stock company, the partnership, the association, the trust, etc., or as individuals. Furthermore, they may change from one form of organization to another and carry on their future operations in the new form regardless of the fact that the result is to raise or lower taxes under the Revenue Laws, provided the transaction is not a mere shift.

A succinct statement of the principle is to be found in Cooley on Taxation (3d ed.), at page 769, as follows:

> While one may lawfully dispose of his property to avoid taxation, a mere manipulation under the guise of disposition, the only effect of which is to avoid the tax, will not be upheld. *People* v. *Sawyer*, 56 N. Y. Super. Ct. 760 (27 N. Y. Supp. 202); *Ransom* v. *Burlington*, 111 Iowa, 77.

For other authorities sustaining the power of courts to look through sham devices to avoid taxation and measure the rights of the parties by the real nature of the transaction, see *Holly Springs, etc.*, v. *Supervisors*, 52 Miss. 281; *Jones* v. *Seward Co.*, 4 N. W. 946; *Mitchell* v. *Commissioners*, 9 Kansas 344; 91 U. S. 206; *Albany City National Bank* v. *Maber*, 19 Blatch. 175; *Shotwell* v. *Moore*, 16 N. E. 470, 129 U. S. 590; *Durham* v. *State*, 32 N. E. 104; *Peppleton* v. *Yamhill*, 8 Oreg. 337; *Ransom* v. *Burlington*, 82 N. W. 427.

In the leading case of *Sisler* v. *Foster*, 74 N. E. 639, the plaintiff transferred to another by deed of trust certain land, reserving to himself full control thereof, and sought to enjoin the county auditor from assessing tax upon such property. In holding the transaction to be a sham device to escape taxation the Ohio Supreme Court said:

> Nobody seems to doubt that the real purpose of Foster was to prevent this property being taxed to the village. The claim is that he had a right to do so. It is not doubted that the owner of property may change its form—as from the stock of a foreign to that of a domestic corporation, or from personal to real to avoid taxation; or that he may, provided the transaction is not a mere shift, change from money which is taxable, to United States securities, which are not; or he may change his residence for the purpose of avoiding taxation. In any such case the motive does not concern anyone else or the public. But we have no such case here.

Applying the above principle to the facts of the case at hand and giving to the facts a meaning most favorable to the taxpayers, it must be held that the device adopted is a mere shift to escape taxation,

and as such ineffectual. The avowed purpose of the change of form, the substantial identity of all parties to the transaction, the coincidence of trustees and beneficiaries, and the fact that the sales occurred within a short time after the dissolution and transfer and were in two cases already arranged for and in the other three contemplated, negative the view that the changes in form were intended to be anything more than an ingenious scheme to shift the burden of taxation to those more conscientious, if less ingenious.

If the purpose of the shift is to escape taxation, the attempt will not be recognized by the courts, even though the tax which it is attempted to avoid is not yet due. Thus, it was held in a leading Missouri case that—

A colorable sale of a strip off of the front of a duly platted and recorded city plot, made with the intent of avoiding a betterment tax about to be assessed against the plot, will not operate to exempt it. *Stifel* v. *Brown*, 24 Mo. App. 102.

It is accordingly held that a change of form from that of a corporation or association to that of a trust or partnership accompanied by a transfer of capital assets to trustees for the benefit of shareholders followed by a sale of such assets at a price in excess of the cost thereof to the corporation or association, and the distribution of proceeds to the beneficiaries (shareholders), such change being made for the main purpose of avoiding the tax which would accrue to the corporation had the sale been made by it, should be disregarded as a mere sham to avoid assessment of tax against the corporation or association upon the profit derived from such sale, and the corporation or association should be required to return as income any profit derived as though the sale had been made by it directly.

SECTION 231.—CONDITIONAL AND OTHER EXEMPTIONS.

SECTION 231, ARTICLE 513: Mutual savings banks. 22–20–974 O. D. 528

A savings fund association has no capital stock represented by shares and derives its entire income from investments of deposits, the income being divided pro rata among all the members after deducting operating expenses. The members who are required to be depositors elect the board of trustees from their number and these trustees in turn elect officers.

Held, that this association is exempt from taxation as a mutual savings bank not having capital stock represented by shares as provided by section 231(2) of the Revenue Act of 1918.

SECTION 231, ARTICLE 514: Fraternal beneficiary societies. 20–20–940 O. D. 508

The M Association is an incorporated society operating under the lodge system throughout the United States, its charter providing for the union of eligible members into a grand fraternal beneficiary, educational and patriotic society. Assessments are levied upon its members to provide for the payment of sick and death benefits, for

disability relief in case of accident and for promoting their social, moral, educational and patriotic advancement. It also derives income from subscriptions to a daily and a weekly newspaper which it publishes as well as from job printing and other sources. None of the income inures to the benefit of any private stockholder or individual.

Held, that although this society has fraternal and benevolent features it is chiefly a patriotic organization interested in the general welfare of its members and that its powers are so extensive as to preclude its classification under paragraph 3, section 231 of the Revenue Act of 1918.

While it is possible that some branch of the organization comes within the provisions of the Act, the society as a whole is not an exempt organization and must, therefore, file returns of annual net income and pay any taxes thereby shown to be due.

SECTION 231, ARTICLE 517: Religious, charitable, scientific, and educational corporations.

(See 5-20-716; sec. 214(a) 11, art. 251.) Community Service (Inc.), an exempt corporation.

SECTION 231, ARTICLE 517: Religious, charitable, scientific, and educational corporations.

(See 8-20-755; sec 214(a) 11, art. 251.) Status of corporations organized for erecting and maintaining monuments and like memorials.

SECTION 231, ARTICLE 517: Religious, charitable, scientific, and educational corporations. 11-20-786 A. R. M. 36

A corporation was organized for the purpose of acquiring and holding title to land and erecting thereon suitable buildings for conducting an assembly or chautauqua, religious, educational, and recreational in character. It derives income from ground rentals, sales of tickets, advertising space, hotel accommodations, etc. All expenditures made are in connection with hiring talent and entertainment and the upkeep of buildings and grounds. It is stated that none of the income is paid to any stockholder or individual, but the articles of incorporation and the by-laws do not prohibit the payment of dividends. Apparently, if the corporation goes out of existence, its stockholders would benefit directly through the distribution of the assets, as well as through the appreciation of such assets since their acquisition by the corporation.

Held, that the corporation does not come within the provisions of section 231(6), Revenue Act of 1918, and is required to file returns and pay any tax shown to be due.

SECTION 231, ARTICLE 517: Religious, charitable, scientific and educational corporations. 20–20–941 O. D. 509

A branch of the Y. W. C. A., established for the purpose of marketing the needlework of self-supporting women, which pays to the producers the full selling price of the goods sold, less a certain commission which only partially defrays the running expenses of the enterprise, the deficit being derived from income of the Y. W. C. A. and from voluntary contributions, is held to be an organization operated exclusively for charitable purposes within the provisions of section 231(6) of the Revenue Act of 1918.

SECTION 231, ARTICLE 517: Religious, charitable, scientific and educational corporations. 20–20–942 O. D. 510

The M Company is an incorporated publishing house, without capital stock, which is owned and controlled by a certain religious denomination. Its business consists strictly of printing religious publications in the form of books, tracts, Sunday-school lessons, catalogues, periodicals, etc., and distributing them to the various branches of the church and members of congregations. It does no business for the general public.

While it is shown that this publishing house has been conducted at a profit, none of the income inures to the benefit of any private individual, being paid over in its entirety to the treasurer of the church for the exclusive benefit of the church.

It appears clear that the predominant purpose of this publishing house is to advance the cause of Christianity by printing and distributing useful literature and that the profits earned and turned over to the church are incidental to this purpose.

The courts favor tax exemptions which pertain to charitable, religious, or educational institutions upon the theory that such institutions relieve burdens of the Government. *Congregational Church School Publishing Society* v. *Board of Review, Chicago*, 125 N. E. Rep. 7. In that decision it was held that the property of a charitable organization which comes fairly within the terms of the exemption provided by the revenue act will be exempt from taxation.

It is held, therefore, that the purposes and activities of the M Company bring it within the provisions of paragraph 6, section 231 of the Revenue Act of 1918. Consequently it will not be required to file returns of annual net income.

SECTION 231, ARTICLE 517: Religious, charitable, scientific, and educational corporations.

(See 22–20–971; sec. 214(a) 11, art. 251.) Corporation engaged in disseminating propaganda to encourage labor legislation.

SECTION 231, ARTICLE 518 · Business leagues. 21–20–960
O. D. 522

The X Association is a corporation organized for the purpose of fostering, developing, and promoting scientifically a certain industry, and has no capital stock represented by shares. The funds for maintaining the association are derived from assessments against the individual firms comprising its membership and annual dues, and such dues and assessments are its only sources of income other than interest on bank deposits and Liberty bonds. These bonds have been purchased from excess surplus funds, which in accordance with a provision of the by-laws are to be refunded to those contributing the same in the same proportion as the amounts were collected. They are the only securities owned by the association, and the interest accruing therefrom is not credited or distributed to any member, but is used in meeting current expenses. The association is not authorized to invest funds for the purpose of profit, or make distribution thereof by way of dividends.

Held, that the association is not actively engaged in the operation of a business from which profits are realized, and that it is exempt from taxation as a business league under the provisions of section 231(7) of the Revenue Act of 1918.

SECTION 231, ARTICLE 519: Civic leagues. 14–20–834
(Also Section 214(a) 11, Article 251.) O. D. 439

The American Legion is a civic organization operated without profit exclusively for the promotion of social welfare, and as such is exempt from taxation under section 231(8) of the Revenue Act of 1918. Individuals may not deduct contributions to the Legion in their returns, since it does not come within the meaning of any of the organizations mentioned in section 214(a) 11 of the Act.

SECTION 231, ARTICLE 521: Mutual insurance companies and like organizations. 23–20–989
O. D. 538

A number of manufacturers incorporated as a reciprocal indemnity exchange to insure their business against fire loss on the reciprocal and interinsurance plan through an attorney in fact having the power to issue policies, collect premiums, and adjust losses. The business is not conducted for profit and no member of the exchange receives any profit therefrom. The contract of insurance or power of attorney signed by each member provides that there shall be no capital stock or joint funds, but that each subscriber shall act individually and shall deposit a fixed amount to meet losses, such amount being kept in a separate account in the name of the depositor. At the end of the period for which the insurance runs any balance of this amount is returned to the depositor.

Held, that this exchange comes within the exemption provided in paragraph 10, section 231 of the Revenue Act of 1918 and will not, therefore, be required to file returns of annual net income.

SECTION 231, ARTICLE 522: Cooperative associations. 21–20–961 O. D. 523

The X Company is a business activity organized for the purpose of affording employment to the members of a certain labor union. It is not a part of the union as such, although it is owned and controlled by the union. Wages are paid to the members employed, and all profits after paying expenses are turned into the treasury of the union.

Held, that the activities of the company are such as to make it a business enterprise. Hence it does not come within the exemption as a labor organization provided in section 231(1) of the Revenue Act of 1918, and will, therefore, be required to file returns of net income.

SECTION 233.—GROSS INCOME DEFINED.

SECTION 233, ARTICLE 542: Sale of capital stock.

(See 21–20–954; sec. 214(a) 4, 5, 6, art. 144.) Interest paid by stockholders where stock sold to them on credit.

SECTION 233, ARTICLE 544: Sale and retirement of corporate bonds. 17–20–887 O. D. 475
(Also Section 202, Article 1561.)

Amortization of premium or discount on bonds as contemplated in articles 544, 563, and 848, Regulations 45, is not permissible in the case of the purchaser of bonds. The purchase price of the bond, even though different from par represents the investment. When the bonds mature or are sold the basis for determining the gain or loss is their purchase price, or their fair market value as at March 1, 1913, if acquired prior to that date.

SECTION 233, ARTICLE 545: Sale of capital assets. 2–20–676 A. R. M–21

If, upon the sale of the capital assets of a corporation to another corporation, shares of stock are surrendered by the old stockholders to the vendee corporation, the nature of the transaction is not changed from one of the sale by the corporation to one of sale of stock by the stockholders.

SECTION 233, ARTICLE 545: Sale of capital assets.

(See 19–20–928; sec. 230, art. 503.) Change of form of organization to avoid the tax which would otherwise accrue to a corporation on profits realized from the sale of assets.

SECTION 233, ARTICLE 548: Gross income of insurance companies.

(See 23–20–991; sec. 234, art 569.) Net decrease in reserve funds as addition to gross income of insurance companies.

SECTION 233, ARTICLE 550: Gross income of foreign corporations. (Also Section 221, Article 362.) 4–20–708 O. D. 384

Under the terms of a contract, a domestic corporation purchased abroad from a foreign corporation goods at a minimum price for resale in the United States. If sold for more than the minimum price, the domestic corporation was to receive a commission, and after deducting certain expenses and the commission, the net profit was divided between the domestic corporation and the foreign corporation. The share of the profits so received by the foreign corporation represents income from sources within the United States but is not subject to the withholding provisions of the Revenue Act of 1918 since it is not "fixed or determinable income" within the meaning of the Act. However the domestic corporation acting as agent of the foreign corporation with respect to goods sold in the United States must file a return of income (Form 1120) for the foreign corporation and pay any tax found to be due.

SECTION 233, ARTICLE 550: Gross income of foreign corporations.

(See 23–20–985; sec. 213(c), art. 91.) Taxability of profit from foreign securities purchased in United States at a discount.

SECTION 234.—DEDUCTIONS ALLOWED.

SECTION 234, ARTICLE 561: Allowable deductions. 1–20–660 O. 968

INCOME TAX: REVENUE ACT OF 1916, TITLE I, SECTION 12(a); REVENUE ACT OF 1918, TITLE II, SECTION 234(a) 4.

Deductions by Corporation. Losses from Marginal Speculating in Stocks. Losses in ultra vires Transactions.

(1) Where a corporation is authorized by its charter or certificate of incorporation to purchase stocks on a margin, and where there are no laws in the State where it trades in stocks making marginal stock transactions by corporations illegal, if it sustains a loss as a result of marginal trading in stocks, such loss may be deducted in computing its net income, if sustained during the taxable year and not compensated for by insurance or otherwise, unless it appears affirmatively that the transaction was merely colorable and no bona fide purchase of stock was made.

(2) Where a corporation suffers losses as a result of its ultra vires act no deduction for such losses may be made in computing its net income.

Opinion is requested as to whether a corporation may claim as a deduction in computing its net income—(1) Losses arising through marginal trading on the stock exchange. (2) Losses incurred in ultra vires transactions. (3) Whether a corporation can claim as a deduction in computing its net income for the year 1917 losses sustained during that year as a result of marginal trading on the stock exchange.

Revenue Act of 1916, Title I, Section 12(a), provides in part as follows:

> 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 * * *
>
> All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, 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 1918, Section 234(a) 4, is as follows:

> 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; * * *.

(1) Are losses sustained by a corporation as a result of marginal trading on the stock exchange deductible in computing its net income?

The Statute places no express limitation upon the losses which may be deducted by a corporation beyond specifying that they must be sustained within the year (and under the 1916 law, charged off the books) and not compensated for by insurance or otherwise. Yet it is apparent that Congress did not intend that all losses should be deducted by corporations. Regulations 45, article 141, contains the following sentence: "Losses in illegal transactions are not deductible." (Law Opinion 282.)

A transaction in the nature of a wagering contract is universally held to be an illegal transaction, *Erwin* v. *Williar*, 110 U. S., 499, 506, so that any losses sustained in such a transaction can not be deducted. A purchase of stock on margin for speculation, however, is not necessarily a wagering contract. If it is the intention of the parties that a real purchase shall be made by the broker, although the delivery may be postponed or made to depend on future conditions, the transaction is legal. *Wagner* v. *Hildebrand*, 187 Pa., 141, 41 Atl., 34, 36; *Rice* v. *Winslow*, 180 Mass., 500, 62 N. E., 1057; *Richter* v. *Poe*, 109 Md., 20, 71 Atl., 420; *Hurd* v. *Taylor*, 181 N. Y., 231, 73 N. E., 977; *Clews* v. *Jamieson*, 182 U. S., 461. Therefore, unless by the laws of the State where the transaction takes place purchases of stock on margin by a corporation are held to be illegal, it is not necessarily unlawful for a corporation to so trade, provided it is authorized to do so by its charter or certificate of incorporation.

(2) Are losses sustained by a corporation in an ultra vires transaction deductible in computing its net income?

The Revenue Act of 1916, in section 5(a) provides, in computing net income in the case of an individual, only for the deduction of losses actually sustained during the year, incurred in trade or business or arising from fires, storms, shipwrecks, or other casualty, or theft, where such losses are not compensated for by insurance.

By the Revenue Act of 1918, section 214(a), the losses which may be deducted by an individual have been extended to include those sustained during the taxable year and not compensated for by insurance, if incurred in any transaction entered into for profit, though not connected with the taxpayer's trade or business. Such losses, however, are limited to those sustained in lawful transactions. (Regulations 45, art. 141.) Congress appreciated the fact that individuals can and do frequently engage in lawful transactions for profit outside of their trade or business and by the present law makes losses suffered in such transactions deductible.

On the other hand, the section of the Act providing for deductions of losses suffered by corporations, remains substantially the same as in the Revenue Act of 1916. Clearly it was not the intention of Congress in the Revenue Act of 1916 to favor corporations over individuals in so far as the deduction of losses are concerned. But in the case of corporations it was unnecessary to insert after the word "losses" the words "incurred in trade or business," since a corporation from its very nature is incapable of engaging lawfully in any but the trade or business which by the provisions of its charter or certificate of incorporation it is authorized to engage in. Losses sustained by a corporation in transactions entered into beyond the scope of the corporate powers would necessarily be sustained in an unlawful transaction, and therefore not be deductible.

That such was the intent of Congress in enacting the various income-tax laws, including the present Act, seems evident upon a consideration of the attitude consistently taken by the Federal Courts in passing upon the legality of ultra vires contracts. Where suits have been brought on such contracts, the Supreme Court has held again and again that the contract being ultra vires was unlawful and void and no recovery could be had upon it. *Pullman's Car* v. *Central Transportation Co.*, 171 U. S. 138, 159; *Louisville, etc., R. R.* v. *Louisville Trust Co.*, 174 U. S. 552, 567; *McCormick* v. *Market Bank*, 165 U. S. 538, 549, 550; *Pittsburgh, etc., R. R. Co.* v. *Kookuck*, 131 U. S. 371. These decisions are based upon the ground of public policy and in order to protect the rights of stockholders in the corporation.

It is true that many State courts take a different view from the Federal courts as to the enforceability of ultra vires contracts. In such States ultra vires contracts are held to be voidable and not void, where the public interest is not involved and where by upholding the ultra vires act no injustice is done to anyone. Although the State has the power to interfere, it will not ordinarily do so, unless the rights of the public are involved. In these States the parties to the ultra vires contract are estopped to deny its validity. Yet where the ultra vires act of a corporation may result in losses which will reduce the taxes collectible by the Government from such corporation, it would seem that the public interest was directly involved, and that in so far as the interest of the public was concerned such act was against public policy and unlawful.

It is fair to assume that this was the attitude of Congress in enacting the provisions of the Revenue Acts of 1916 and 1918 in regard to the deduction of losses suffered by corporations. Congress did not intend that a corporation should deduct losses sustained in an ultra vires transaction.

In the present case it is unnecessary to consider whether or not any exception to the above rule should be made in cases where a corporation commits an ultra vires act as a result of bona fide mistake as to the scope of its corporate powers or where such act is without the consent and against the wishes of its stockholders.

It is, therefore, held (1) that where a corporation is authorized by its charter to purchase stocks on a margin, and where there are no laws in the State where it trades in stocks making marginal stock transactions by corporations illegal, if it sustains a loss as a result of marginal trading, such loss may be deducted in computing its net income, if sustained during the taxable year and not compensated for by insurance or otherwise, unless it appears affirmatively that the transaction was merely colorable and no bona fide purchase of stock was made; (2) that where a corporation suffers losses as a result of its ultra vires act, no deduction for such losses may be made in computing its net income.

SECTION 234, ARTICLE 561: Allowable deductions.

(See 7–20–745; sec. 250, art. 1003.) Interest paid or accrued under section 250.

SECTION 234, ARTICLE 561: Allowable deductions.

(See 8–20–754; sec. 214(a) 3, art. 131.) Deductibility of Federal income tax in return of corporation for fiscal year ending in 1917, prior to October 3.

SECTION 234, ARTICLE 561: Allowable deductions. 14–20–835
O. D. 440

A royalty paid by a corporation to one of its officers, who is also a majority stockholder, for the use of a patent upon an article manufactured and sold by the corporation is deductible as a business expense, provided the amount so paid is reasonable, considering the value of the invention and its salability in the open market. Any payment so made in excess of a reasonable amount, taking into consideration all of the facts in the particular case, would represent a distribution of profits, and consequently would not be deductible.

SECTION 234, ARTICLE 561: Allowable deductions.

(See 20–20–934; sec. 214(a) 1, art. 101.) Deduction of amounts expended in litigation defending title to a patent.

SECTION 234, ARTICLE 561: Allowable deductions.

(See 20–20–935; sec. 214(a) 1, art. 105.) Increased compensation of officers of corporation authorized immediately prior to close of fiscal year.

SECTION 234, ARTICLE 561: Allowable deductions.

(See 20–20–938; sec. 214(a) 10, art. 203.) Basis for claiming deductions under section 12(a), Revenue Act of 1916, where mining lease was purchased by a corporation with its entire issue of capital stock.

SECTION 234, ARTICLE 561: Allowable deductions. 22–20–975 O. D. 529

Payments to trustees by a cemetery corporation during the taxable year of a certain percentage of the proceeds of sales of cemetery lots set aside for a maintenance fund to be controlled solely by the trustees thereof are not deductible from the gross income of the corporation even though such payments are required by State law.

SECTION 234, ARTICLE 564: Interest.

(See 21–20–954; sec. 214(a) 4, 5, 6, art. 144.) In re interest deduction of a corporation under Act of October 3, 1913, and Revenue Act of 1916.

SECTION 234, ARTICLE 569: Required addition to reserve funds of insurance companies. 13–20–816 O. D. 427

The decision of the United States Supreme Court in *Maryland Casualty Company* v. *United States* does not authorize any insurance company to deviate from the present method of computing the "net addition to reserve funds" deductible from gross income. The amount deductible is the excess of the total reserve funds as required by law at the end of the taxable year over the total of such reserve funds at the beginning of the year regardless of the fact that during the year the reserve funds are increased on account of new business, and decreases in such funds are inevitable when policies mature, lapse, or are surrendered.

SECTION 234, ARTICLE 569: Required addition to reserve funds of insurance companies. 23–20–991 L. O. 1032
(Also Section 233, Article 548.)

INCOME TAX: SECTION 38, ACT OF AUGUST 5, 1909, AND PARAGRAPH G(a), (b), ACT OF OCTOBER 3, 1913.

Reserve funds "required by law" include not only reserves required by express statutory provisions but also reserves required by the rules and regulations of the State insurance departments when promulgated in the exercise of an appropriate power conferred by statute, but do not include assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance, and unpaid brokerage.

Where there is a net decrease in the reserve funds required to be maintained by an insurance company, so much of the decrease as is released to the general uses of the company and increases its free assets is income to the company.

Any net decrease in reserves shall be added to the gross income, unless the company shall show that such decrease resulted from the application of reserves to the purposes for which they were established.

An opinion is requested as to the effect upon the present practice of the Bureau of the decision of the Supreme Court of the United States in the case of *Maryland Casualty Company* v. *United States*, handed down January 12, 1920.

Section 38 of the Act of August 5, 1909 (Corporation Excise Tax Act) provides that every insurance company organized under the laws of the United States or of any State or Territory of the United States shall be subject to pay annually a special excise tax with respect to carrying on or doing business by such insurance company "equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year, * * *"; and further provides that such net income shall be ascertained by deducting from the gross income of such company, among other things, "the net addition, if any, required by law to be made within the year to reserve funds."

Paragraph G(a) of the Act of October 3, 1913, provides that the normal tax imposed upon individuals shall likewise be levied, assessed, and paid annually "upon the entire net income arising or accruing from all sources during the preceding calendar year" by "every insurance company organized in the United States, no matter how created or organized, * * *"; and subdivision (b) of section G provides that:

> 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, * * * (second) * * * in case of insurance companies the net addition, if any, required by law to be made within the year to reserve funds * * *.

The Maryland Casualty Company is an insurance company incorporated under the laws of the State of Maryland, and upon its returns for the years 1909 to 1913, inclusive, under the Acts of August 5, 1909, and October 3, 1913, it claimed the right to deduct under the item "net addition to reserve funds" additions made to "reserve for unearned premiums," "special reserve for unpaid liability losses," "loss claims reserve," and also reserve for "unpaid taxes, salaries, brokerage, and reinsurance due other companies." The Government, in its amended returns, allowed the additions of "reserve for unearned premiums" and "special reserve for unpaid liability losses," but rejected the others.

As indicated in the decision of the Court of Claims in this case, the return for the year 1913 showed an increase in the "unearned premium reserve" of $81,784.67, but a decrease in the "special reserve for unpaid liability losses" of $352,252, making a net decrease in the reserve funds of the company of $270,467.33.

The case of *McCoach* v. *Insurance Company of North America*, 244 U. S. 565, related specifically only to the reserve required in the State of Pennsylvania to be maintained by a fire and marine insurance company against unpaid losses, and it was held that such a reserve was not a reserve required by law; but the rule laid down by that case clearly was that only reserves required by express statutory provision were to be included in "reserves," the net addition to which might be deducted from gross income in determining the net income of an insurance company.

In the case of *Maryland Casualty Company* v. *United States* the rule laid down in *McCoach* v. *Insurance Company of North America*

(supra), in so far as it held that reserves required by express statutory provision were to be included in reserves "required by law," was recognized and applied, but it was also held that "reserves required by the rules and regulations of State insurance departments when promulgated in the exercise of an appropriate power conferred by statute" were to be included in such reserves. Thus, by implication the ruling in the case of *McCoach* v. *Insurance Company of North America*, in so far as it limited reserves "required by law" to those required by express statutory provision, was overruled.

Although the Insurance Company of North America is a fire and marine insurance company, and the Maryland Casualty is a company engaged in casualty, liability, fidelity, guarantee, and surety insurance, but especially in employers' liability, accident, and workmen's compensation insurance, the rules stated were not based upon any peculiarities of such insurance companies, and are clearly applicable to insurance companies generally.

This brings us to the more important question of the effect of a net decrease in the reserves, "required by law" as above defined, to be maintained by an insurance company. Upon this point the rule, as stated in *Maryland Casualty Company* v. *United States*, is that:

> If in this case it (a decrease in the aggregate of reserve requirement) were due to an overestimate of reserves for 1912 with a resulting excessive deduction for that year from gross income and if such excess was released to the general uses of the company and increased its free assets in 1913, to that extent it should very properly be treated as income in the year in which it became so available for the reason that in that year for the first time it became free income, under the system for determining net income provided by the statute, and the fact that it came into the possession of the company in an earlier year in which it could be used only in a special manner, which permitted it to become nontaxable would not prevent its being considered as received in 1913 for the purposes of taxation, within the meaning of the Act.

Applying this rule to the case before it the court said:

> The findings of fact in this case, however, do not show that the diminution in the amount of required reserves was due to excessive reserves in prior years or to any other cause by which the free assets of the company were increased in the year 1913, * * *

and concluded:

> Since the findings of fact before us do not make the clear showing, which must be required, that the statutory deduction of net reserves in prior years was restored to the free use of the claimant in 1913, it should not have been charged as income with the decrease in that year, and on the record before us the holding of the Court of Claims must be reversed.

This holding is to be understood only in connection with the particular facts in the case. The statement of facts shows that during the year 1913 there was an increase in the unearned premium reserve in round numbers of $80,000, but that there was a decrease in the employers' liability loss reserve which the company was required to hold at the end of the year 1913 of, to use round numbers again, $350,000, making a net decrease in the reserves of $270,000. The net decrease, therefore, was wholly due to the fact that the reserve required to be maintained against the employers' liability loss existing at the close of the year 1913 was less than that which it was required to maintain at the close of the year 1912. The court was, therefore, concerned wholly with the "employers' liability loss reserve." "The employers' liability loss reserve" is one required to

be maintained by a casualty insurance company to cover claims on file by the employers insured, and, to a certain extent, claims anticipated to be filed during the coming year. These reserves then are held against specific losses already existing or anticipated. It is evident that when the losses against which such reserves are held have all been paid the entire reserve will have been released. If the amount of the claims finally allowed equals the amount of the estimated reserves held against them such reserves will have been entirely employed in the payment of the losses against which they were established, and nothing will have been released to the general uses of the company so as to increase its free assets. If, on the other hand, the amount paid out in the satisfaction of claims is less than the amount of the reserves required to be maintained the difference will have been released "to the general uses of the company," i. e., it will become a part of the general surplus not specifically held. It will, therefore, increase the "free assets" of the company, and, under the express holding in *Maryland Casualty Company* v. *United States*, it will become income to the company in the year in which it is so released.

The findings of fact in the *Maryland Casualty Company* v. *United States* did not show what portion of the assets held against employers' liability loss at the close of the year 1912 was actually applied during the year 1913 to the satisfaction of losses and what portion was released to general surplus, and it was for this reason that the court said that—

> Since the findings of fact before us do not make the clear showing, which must be required, that the statutory deduction of net reserves in prior years was restored to the free use of the claimant in 1913, it should not have been charged as income with the decrease in that year * * *.

Although the court had under consideration only one class of reserves the rule stated is clearly of general application to any class of reserves, net additions to which are "required by law" to be made. Although the reserves of an insurance company, other than a life insurance company, are generally speaking only a percentage of its surplus which may not be distributed in dividends, the effect is not different than if they were separate and distinct funds. The "unearned premium reserve" is not only a guarantee of payment of the policies against which it is held but also a fund to which resort may, in case of necessity, be made for payment of losses thereunder. If, during the life of any policy, a loss occurs the reserve established for the protection of such policy is released, and to that extent the reserve fund is reduced. If the reserve exceeds the amount of the loss and the policy is not continued in force, the excess becomes part of the general surplus of the company; it is "released to the general uses of the company." If, on the other hand, no loss is incurred by the policy holder, upon the expiration of the policy, the whole amount of the reserve held against it is released to the "general uses of the company" and increases its "free assets."

In any case, therefore, in which there is a net decrease in the reserve funds of an insurance company it must first be determined to what extent the reserves thus released have been applied in the payment of the losses against which they are held, and to what extent they exceed the actual losses paid, and are, therefore, released to the

"general uses of the company." So much of the released reserve as is applied to the payment of losses never becomes "free assets" of the company, and is not income of the company; but any excess which is released to general surplus thus becoming "free assets" available for any purposes of the company is income to the company in the year in which it is released, and is to be added to the gross income.

It is accordingly held that: Reserve funds "required by law" include not only reserves required by express statutory provisions, but also reserves required by the rules and regulations of State insurance departments when promulgated in the exercise of an appropriate power conferred by statute; but do not include assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance, and unpaid brokerage.

Where there is a net decrease in the reserve funds required to be maintained by an insurance company, so much of the decrease as is released to the general uses of the company and increases its free assets is income to the company.

Any net decrease in reserves shall be added to the gross income, unless the company shall show that such decrease resulted from the application of reserves to the purposes for which they were established.

WAYNE JOHNSON,
Solicitor of Internal Revenue.

SECTION 234, ARTICLE 572: Special deductions allowed mutual insurance companies. 7–20–744 O. D. 403

The following procedure will be followed in making final audit and assessment of returns of mutual fire and mutual casualty insurance companies, with reference to the deduction for premium deposits retained for the payment of losses, expenses and reinsurance reserves authorized in section 234(a) 13 of the Revenue Act of 1918:

In determining the amount of deduction to be allowed for premium deposits retained, a company may begin with the premium deposits written during the tax year. From this amount will be subtracted any portion of such premium deposits written during the year which are not retained at the end of the year. The only portion of such premiums written during the year which may be considered as retained is that portion in excess of the amounts paid or incurred for losses and expenses during the year or returned to policyholders during the year. If there is no such excess, then it is to be presumed that any net income or increase in surplus shown by a company is derived, not from premiums retained but from other sources than premiums. It is not to be presumed that in determining the portion of premium income received during the year which is retained during the year that payments made by the company during the year are made out of funds other than premiums.

The result of this procedure will be generally that companies, under section 234(a) 13, will be permitted to deduct their entire premium income and will generally be taxed upon their remaining income which consists in this class of companies mainly of interest.

NOTE.—Overruled by L. O. 1050; ruling 40–20–1226.

SECTION 236.—CREDITS ALLOWED.

SECTION 236, ARTICLE 591: Credits allowed.

(See 4–20–706; sec. 216, art. 301.) Credit allowed to corporations for the purpose of the 4 per cent war income tax imposed by section 4, Revenue Act of 1917, in the case of dividends received from foreign corporations taxable upon income from sources within the United States.

SECTION 237.—PAYMENT OF TAX AT SOURCE.

SECTION 237, ARTICLE 601: Withholding in the case of nonresident foreign corporations. 1–20–661 O. D. 358

Appointment by a nonresident alien banking corporation of a resident agent in the United States, who has authority to make returns for the corporation, will relieve a domestic bank from the responsibility of withholding tax at 10 per cent from the interest credited to the account of the foreign bank, provided the agent furnishes a certificate stating that the foreign corporation has an office or place of business in the United States and that he will make all necessary returns and pay all taxes shown to be due.

SECTION 237, ARTICLE 601: Withholding in the case of nonresident foreign corporations.

(See 16–20–865; sec. 221, art. 362.) Status for withholding purposes of income from collection, purchase, and sale of bank acceptances in United States on behalf of foreign corporation.

SECTION 237, ARTICLE 601: Withholding in the case of nonresident foreign corporations.

(See 24–20–1007; sec. 221, art. 362.) Interest on call loans made by domestic bank for account of foreign bank.

SECTION 238.—CREDIT FOR TAXES.

SECTION 238, ARTICLE 611: Credit for foreign taxes. 8–20–757 O. D. 406

A domestic corporation which derives its entire income from operations in Cuba and keeps its books on an accrual basis, may file on Form 1118 a "claim for credit" of the amount of any Cuban income, war profits or excess profits tax accrued for the fiscal year ended June 30, 1918, and apply such credit against its Federal income and profits tax for the same fiscal period. This credit should be prorated with reference to that part of the fiscal year falling within the calendar year 1918. If the 1918 Federal tax has been paid without claiming this credit and the company wishes to credit the overpayment

against the 1919 taxes, Form 1118 should be accompanied by a claim for refund on Form 46 and possibly a claim for credit on Form 47–A.

A claim for credit on Form 1118 for the amount of Cuban income, war profits or excess profits tax accrued for the fiscal year ended June 30, 1919, may be filed and applied against the company's Federal tax liability for the same fiscal period.

SECTION 239.—CORPORATION RETURNS.

SECTION 239, ARTICLE 621: Corporation returns. 2–20–677
O. D. 365

If the charter board of a State declared the charter of a corporation forfeited but the corporation had no notice of such action and continued to do business for a number of years as a corporation and made returns to the Federal Government accordingly, the corporation can not now set up the action of the charter board to negative its corporate existence.

Until the company surrenders its charter to and the same is annulled by the State, or the charter is annulled in some other manner and the company ceases to operate as a corporation, it must be held to be a corporation for income and profits tax purposes and will be required to file returns accordingly.

SECTION 239, ARTICLE 621: Corporation returns.

(See 3–20–697; sec. 331, art. 941.) Returns required from a corporation when there is a transfer of domicile through the surrender of the charter issued in one State and the taking out of a new charter in another State.

SECTION 239, ARTICLE 621: Corporation returns. 17–20–888
O. D. 476

Since in the conversion of a State bank into a national bank there is not a dissolution of the corporation, but merely a change of title and the extension of Government supervision thereover, a bank so changing during the taxable year must file one return for the entire year.

SECTION 239, ARTICLE 622: Returns by receivers. 11–20–787
O. 1009

INCOME TAX: ACT OF OCTOBER 3, 1913.

Corporation in Hands of Receiver.

The net income of a corporation in the hands of a receiver who is operating strictly as the officer of a court and is subject to its orders is not taxable under the Act of October 3, 1913. This ruling does not apply to the net income of a corporation in the hands of trustees or voluntary liquidators not so acting.

The Act of 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 * * * organized in the United States, no matter how created or organized * * *. (38 Stat., 176.)

All corporations, joint-stock companies, or associations * * * shall render a true and accurate return under oath or affirmation of its president, vice president, or other principal officer, and its treasurer or assistant treasurer * * *.

The income of corporations organized in the United States, not specifically enumerated as exempt from the tax, is liable to tax and the officers of such corporations are required to make income tax returns.

(1) A receiver who is appointed by and is subject to the orders of a court is an officer of the court; he is not an officer of the corporation and is in nowise subject to the wishes of stockholders of the corporation. Income received by him from the property of the corporation in his possession is not the income of the corporation; it is received primarily for the benefit of the creditors of the corporation.

(2) The Act of October 3, 1913, does not specifically tax income of corporations in the hands of receivers. Receivers in possession of the property of corporations are not required to make returns of the income from the corporate property received by them. As stated by the United States Circuit Court of Appeals in the case of *Scott* v. *Western Pacific Railroad Co.*, 246 Fed., 545:

The next question is whether the Act of Congress of October 3, 1913, applies to receivers of corporations. References to parts of the law, Section II, A to N, inclusive, of the Act of Congress which is generally called the income tax provision shows no express language providing for the imposition and collection of any tax upon corporations in the hands of receivers. Detailed regulation is made for the levy and assessment upon the net income of every corporation, joint-stock company or association, and every insurance company organized in the United States.

That the omission in the Act of October 3, 1913, to include property held by receivers was intentional, is to some extent further shown by referring to the income tax law of September 8, 1916. By section 10 of the Act (39 Stat. L., 765, ch. 463 (Comp. Stat. 1916, 6336j)) provision is made for the levy, assessment, and payment of a tax on the total net income received in the preceding calendar year from all sources by every corporation, joint-stock company, or association, or insurance company, in the same manner that, under the Act of 1913, a tax was imposed on the net income of such associations, corporations or companies. But while the Act of 1913 omits reference to receivers of corporations, the Act of 1916 expressly provides for the inclusion of property held by such receivers, and how receivers shall make returns. Subdivision (c), section 13, Part II, Act of 1916, so far as material, is as follows:

"In cases wherein receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, * * * subject to tax imposed by this title, such receivers, trustees, or assignees shall make returns of net income as and for such corporations, * * * in the same manner and form as such organizations are hereinbefore required to make returns, and any income tax due on the basis of such returns made by receivers, * * * shall be assessed and collected in the same manner as if assessed directly against the organizations of whose businesses or properties they have custody and control."

We have not overlooked the fact that there are in the law of 1913 certain provisions relating to the imposition of taxes in certain instances where there are receivers. "D" and "E" headings, Section II, are to be noticed. "D" provides that guardians, trustees, agents, receivers, and others specified shall make returns of net income for the person "for whom they act subject to this tax," and that they shall be subject to all provisions of the section which apply to individuals. It would seem that the tax referred to is the tax imposed upon individuals referred to in the headings, and the person subject to the tax is one

required to make return, a person (D) of lawful age, except as specially provided, and having a net income of $3,000 or over for the taxable year. The use of the word "receiver" in heading "E" has further to do with fiduciaries who are acting under heading "D" by providing that they shall withhold at the source the normal tax imposed on the individual and make the payments as prescribed of the amounts so held out.

The above case follows that of *Pennsylvania Steel Co.* v. *New York City Railway Co.*, 198 Fed., 775, in which the following language appears:

> It can not be held that an Act which nowhere mentions receivers and which in every paragraph deals with corporations and joint-stock companies actually engaged in business can, by construction, be made to cover the business temporarily undertaken, of conserving the property of such a corporation for the benefit of its creditors and public * * * whatever corporate functions the corporation possessed were in abeyance during the period that the court held the property for the benefit of all the creditors.

3. It is a well recognized rule of statutory construction that the language of a taxing statute is not to be construed to embrace objects of taxation which are not clearly within the language used. This rule of construction has particular application to the present case. The income of a corporation is liable to tax. But income received by receivers of corporate property is not, strictly speaking, the income of the corporation. The language of the taxing statute is not to be extended to embrace it.

The decision of the Circuit Court of Appeals in the case of *Scott* v. *Western Pacific Railroad Co.* (supra) is well reasoned. The Supreme Court was not requested to grant a writ of certiorari for the review of it. This Bureau must accept it as authoritative of the legal principles laid down in the decision.

SECTION 240.—CONSOLIDATED RETURNS.

SECTION 240, ARTICLE 631: Affiliated corporations. 16–20–866 O. D. 467

A corporation, the majority of whose stock is owned by its president and manager, turned over a branch of its business to a new company, not incorporated, the president and manager of the corporation retaining control of the new company. There was no transfer of corporate assets. The new company simply used the assets of the corporation without consideration of any kind but was operated as a separate and distinct enterprise. Held, that the new company is merely a branch of the corporation and not a separate entity for Federal income tax purposes. Its income should be included in the return of the corporation and is subject to both income tax and excess profits tax.

SECTION 240, ARTICLE 632: Consolidated returns.

(See 16–20–868; sec. 256, art. 1071.) Return of information at the source in case of affiliated corporations.

SECTION 240, ARTICLE 633: When corporations are affiliated.

(See 17–20–881; sec. 326, art. 831.) Requirement as to consolidated return from bank and association of stockholders whose ownership of shares in the bank and in a stockholders' trustee account are on the same pro rata basis.

SECTION 240, ARTICLE 633: When corporations are affiliated. 22–20–976 A. R. R. 123

Recommended that the decision of the Income Tax Unit, holding that the M Company and the N Company are not to be deemed affiliated with the O Company within the meaning of the law, be sustained.

The Committee has had under consideration the appeal of the O Company from a ruling of the Income Tax Unit to the effect that the consolidated return of said company may not include invested capital nor income of the M Company and the N Company.

The facts relating to the connection of these two companies with the O Company appear to be that the stock of the N Company is wholly owned by persons not related to the O Company and that the stock of the M Company was similarly owned by outsiders until the date upon which it became affiliated with the O Company, from which time the Unit concedes that the income and invested capital should be included in the consolidated return.

The grounds on which the O Company urges the inclusion of these two companies in its consolidated return are based upon contracts made with the several companies under which the M and N Companies assemble or manufacture machines from parts furnished by the O Company at cost to it, or through it with the various subsidiaries and others with which it has contracts. Under the terms of the contract in the case of the M Company the O Company is to be entitled to 60 per cent of the net profits and in the case of the N Company, 50 per cent of the net profits of the respective corporations. The returns of these two companies were included in the consolidated return of the O Company for 1917.

In Regulations 41, covering 1917, it was held that—

For the purpose of this regulation two or more corporations will be deemed to be affiliated (1) when one such corporation owns directly or controls through closely affiliated interests or by a nominee or nominees, all or substantially all of the stock of the other or others, or when substantially all of the stock of two or more corporations is owned by the same individual or partnership, and both or all of such corporations are engaged in the same or a closely related business; or (2) when one such corporation (a) buys from or sells to another products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or (b) in any way so arranges its financial relationships with another corporation as to assign to it a disproportionate share of net income or invested capital.

The permission to consolidate in 1917 appears to have been based on the provisions of paragraph (2) above. It will be noted that this paragraph is not carried into section 240 of the 1918 law which holds, in paragraph (b), that—

For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through

closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

Thus it will be seen that under the 1918 law in order that corporations may be deemed to be affiliated there must be an ownership or control by one corporation, such as contemplated by the statute, of substantially all of the stock of one or more other corporations or substantially all of the stock of two or more corporations must be owned or controlled by the same interests. It is believed that it was not the purpose of the 1918 Act to class corporations as affiliated merely because of the commercial or financial relations existing between them where there was no stock ownership or stock control of the character and extent prescribed by the statute.

Since the element of stock ownership or stock control is not sufficiently established by the facts presented in this case the Committee reaches the conclusion that the decision of the Unit that the M Company and the N Company are not to be deemed affiliated with the O Company within the meaning of the law is correct, and recommends that its action be sustained.

SECTION 240, ARTICLE 637; Consolidated net income of affiliated corporations. (Also Section 301, Article 714.) — 12-20-799, O. D. 415

The income of affiliated corporations which is derived from Government contracts is taxable (except as provided in sec. 240(a) of the Revenue Act of 1918) upon the basis of the total sum received from that source by the group and not upon the basis of the separate amount received by each corporation.

SECTION 241—TIME AND PLACE FOR FILING RETURNS.

SECTION 241, ARTICLE 651: Time and place for filing returns.

(See 11-20-789; sec. 227, art. 444.) Extension of time for filing corporation returns for 1919.

SECTION 241, ARTICLE 651: Time and place for filing returns. — 25-20-1018, O. D. 557

A corporation whose fiscal year ended on February 28, 1919, was in the hands of a receiver. The receiver was discharged on May 17, 1919. A new certificate of incorporation was filed May 12, 1919.

Held, that the return for the original corporation covering the period from March 1, 1919, to May 17, 1919, should have been filed by the receiver not later than May 15, 1920, the date upon which a return covering the fiscal year ending February 28, 1920, was due.

PART IV.—ADMINISTRATIVE PROVISIONS.

SECTION 250.—PAYMENT OF TAXES.

SECTION 250, ARTICLE 1003: Interest on tax. 7-20-745
(Also Section 214(a) 2, Article 121.) O. 922
(Also Section 234, Article 561.)

INCOME TAX: REVENUE ACT OF 1918, SECTIONS 250, 214(a) 2, 234(a) 2.

Interest paid or accrued under the provisions of section 250, Revenue Act of 1918 is deductible under the provisions of section 214(a) 2 or section 234(a) 2 in computing net income.

Opinion is requested as to whether interest paid under the provisions of section 250, Revenue Act of 1918, should be considered as a part of the tax, and not deductible by a taxpayer as interest in computing net income.

Section 214(a) 2, Revenue Act of 1918, provides as follows:

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

* * * * * * *

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from taxation under this title as income to the taxpayer, or, in the case of a nonresident alien individual, the proportion of such interest which the amount of his gross income from sources within the United States bears to the amount of his gross income from all sources within and without the United States.

Section 234(a) 2 is substantially similar to section 214(a) 2, except that it applies to corporations instead of individuals.

The subdivisions of section 250, Revenue Act of 1918, which provide for the addition of interest to the tax are, in part, as follows:

(a) * * * 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 centum per month from the time it would have been due if no extension had been granted, until paid. * * *

(b) * * * 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.

(e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in case of estates of insane, deceased, or insolvent persons, 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: *Provided*, That as to any such amount which is the subject of a bona fide claim for abatement such sum of 5 per centum shall not be added and the 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. * * *

It would seem clear that for purposes of assessment and collection the interest referred to in section 250 is to be regarded as a part of the tax. Regulations 45, article 1041, provides in part as follows:

* * * An ad valorem penalty is assessed and collected as a part of the tax, * * *.

The question arises, however, whether this interest is for all purposes to be regarded as part of the tax. I am of opinion that such is not the intent of the statute. Sections 214(a) 2 and 234(a) 2 expressly provide for the deduction from gross income of all interest paid or accrued within the taxable year on the indebtedness of an individual or corporation (with certain specific exceptions). Interest paid under the provisions of section 250 is interest within the meaning of sections 214(a) 2 and 234(a) 2, notwithstanding that it is added to the amount of the tax. Had it been intended that interest paid or accrued on income taxes should be excluded from deductions, such exception would have been set forth specifically in sections 214(a) 2 and 234(a) 2, as was done in the case of interest on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from taxation under the income tax.

Sections 214(a) 3 and 234(a) 3, Revenue Act of 1918, which provide for the deduction of taxes paid or accrued within the taxable year, expressly except income, war profits, and excess profits taxes. This exception, however, is not intended to include interest payments made under the provisions of section 250. To so hold would amount to a direct contradiction of the provisions of the previous subdivision expressly providing for the deduction of interest.

Regulations 45, article 382, referring to section 222, Revenue Act of 1918, which provides for credits for foreign taxes paid by citizens or residents of the United States, states in part:

> "Amount of * * * taxes paid during the taxable year" means taxes proper (no credit being given for amounts representing interest or penalties) paid or accrued during the taxable year on behalf of the individual claiming credit * * *

This language shows that as to credits for foreign taxes the regulations distinguish between taxes proper and the interest paid or accrued on the same. In so far as the deduction of interest is concerned, a like distinction should be made between domestic taxes proper and interest paid or accrued thereon. That this has been the attitude taken by the Bureau of Internal Revenue in interpreting earlier Revenue Acts is apparent upon consideration of Law Opinion 582, decided under the Act of October 3, 1913. This opinion holds that where overdue State taxes for certain past years are paid by an insurance company, the amount of such taxes is an allowable deduction from gross income for the year when paid, but that interest on such overdue taxes is not an allowable deduction from gross income except to the extent of such interest accrued during the year for which the return is made. Thus the tax proper is deductible under that statute as "sums paid * * * within the year for taxes," but the interest thereon is deductible not as a tax paid but as "interest accrued and paid within the year."

It is held, therefore, that interest paid or accrued under the provisions of section 250, Revenue Act of 1918, is deductible under the provisions of section 214(a) 2 or section 234(a) 2 in computing net income.

SECTION 250, ARTICLE 1003: Interest on tax. 14–20–836
O. D. 441

In cases where an addition of 25 per cent or 50 per cent is made to the tax on account of delinquency or fraud, and the taxpayer fails to pay the tax within 10 days after notice and demand from the collector, the 5 per cent penalty and interest attach, not only to the amount of tax shown to be due by the return but also to the 25 per cent or 50 per cent addition to the tax.

SECTION 250, ARTICLE 1003: Interest on tax. 18–20–902
O. D. 487

When an extension of time is granted to the Commissioner of Indian Affairs within which to file returns for incompetent full-blood members of the Osage Tribe of Indians, wards of the Government, whose lands or moneys or both are restricted and under governmental supervision, no penalty on account of delinquency attaches, neither shall there be added to any installment of the tax interest thereon at the rate of one-half of 1 per cent per month as provided for in section 250(a) of the Revenue Act of 1918, as that section is held to be inoperative as against the United States.

SECTION 250, ARTICLE 1004: Penalty for failure to file return. 8–20–758
S. 1334
(Also Section 221, Article 376.)

INCOME TAX: REVENUE ACT OF 1918, SECTIONS 1317 (AMENDING REVISED STATUTES, SECTION 3176), 250(b) AND 221(c) AND (e).

(1) The ad valorem penalties for fraudulent returns should be assessed against withholding agents under the income tax provisions of the law.

(2) The ad valorem penalties for delinquent returns should be assessed against withholding agents under the income tax provisions of the law, except that if the tax required to be withheld is paid by the recipient of the income, no such penalty should be collected from the withholding agent unless his delinquency was fraudulent and for the purpose of evading payment.

The question arises as to assessing the ad valorem penalties provided for in the case of delinquent and fraudulent returns when such returns are made by withholding agents under the income tax provisions of the law.

Section 1317, Revenue Act of 1918 (amending section 3176, R. S.), provides in the case of delinquent returns for an addition to the tax of 25 per cent, and in the case of fraudulent returns for an addition to the tax of 50 per cent of its amount.

Section 250(b), Revenue Act of 1918, provides in part that if an understatement is false or fraudulent with intent to evade the tax, then, in lieu of the penalty provided by section 3176, R. S., as amended, there shall be added as part of the tax 50 per cent of the amount of the deficiency.

Section 221(e), Revenue Act of 1918, provides as follows:

If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding

agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

I can see no good reason for distinguishing between taxpayers and withholding agents as regards the assessment of the ad valorem penalties for delinquent or fraudulent returns. It is suggested that if the ad valorem penalty for a delinquent or fraudulent return is assessed against a withholding agent he will indemnify himself out of the funds of the taxpayer in his hands with the result that the burden of the penalty will fall upon the innocent taxpayer instead of upon the guilty withholding agent. I do not feel that this will be the case. Section 221(c), Revenue Act of 1918, provides that the withholding agent shall be liable for the tax which he is required to withhold. It further provides that the withholding agent shall be indemnified against the claims and demands of the taxpayer for the amount of any payments made in accordance with the provisions of this section. Under these provisions the withholding agent is undoubtedly indemnified against the claims of the taxpayer for the amount of any tax which he is liable to pay. The ad valorem penalties for delinquent and fraudulent returns, however, are not a part of the tax except for purposes of collection (Law Opinion 926), and they are not payments made in accordance with the provisions of section 221, Revenue Act of 1918, but in accordance with the provisions of sections 1317 and 250(b) of that Act. Therefore, the withholding agent would not be indemnified against claims of the taxpayer for the amount of these ad valorem penalties.

It is further suggested that as the witholding agent is required to act as a collecting agent for the Government, without compensation and frequently at expense to himself, it is unfair to penalize him in addition for oversight or negligence in reporting promptly. Without passing upon the merits of this argument, it is sufficient to say that Congress has not seen fit to make any distinction in the law between taxpayers and withholding agents in so far as their liability for delinquent and fraudulent returns is concerned.

It is held, therefore, that (1) the ad valorem penalties for fraudulent returns should be assessed against withholding agents under the income tax provisions of the law.

(2) The ad valorem penalties for delinquent returns should be assessed against withholding agents under the income tax provisions of the law, except that if the tax required to be withheld is paid by the recipient of the income, no such penalty should be collected from the withholding agent unless his delinquency was fraudulent and for the purpose of evading payment.

SECTION 250, ARTICLE 1004: Penalty for failure to file return. 13-20-817 S. 1359

REVENUE ACTS OF 1916 AND 1917.

The provisions of law and regulations as to "reasonable cause" and "notice from the collector" in connection with penalties for delinquency in filing returns are applicable only when a return is voluntarily filed after the due date and not when a delinquent return has not been filed.

SECTION 250, ARTICLE 1004: Penalty for failure to file return.

(See 22-20-977; sec. 253, art. 1041.) Penalties not asserted in case of delinquent returns for 1914 filed after expiration of three-year period of limitation.

SECTION 250, ARTICLE 1005: Penalty for understated return. 3-20-692 A. R. M. 24

(Also Section 214(a) 9, Article 184.)

Advice has been requested as to whether or not penalty and interest should be asserted against taxpayers who violate the specific provisions of the regulations and of Treasury decisions modifying or amending such regulations.

The immediate cases under consideration arise specifically in connection with amortization deductions, it being stated that taxpayers have disregarded the instructions laid down in Treasury Decision 2859 and have taken preliminary deductions of more than 50 per cent of the cost of the property to be amortized. The regulations as amended by Treasury Decision 2859 provide that in certain cases "The basis for amortization calculation shall be the estimated value of the property to the taxpayer in terms of its actual use and 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."

From the foregoing it is manifest that the 25 per cent to be taken at the time was a tentative amount and with respect to this class of cases the Committee is of the opinion that the following rule regarding negligence should be observed:

In any case where upon consideration it is held that a taxpayer was in fact entitled to more than 25 per cent as an amortization allowance, the 5 per cent penalty and 1 per cent interest on account of negligence shall apply only to such amount of additional tax due on account of amortization claimed but disallowed in the return for 1918, and in the event that the case is reopened within a period of three years and an additional amount of amortization allowed, the penalty and interest will not attach to the amount of tax based on the additional allowance granted. In other words, penalty and interest should attach only to such amount as upon final settlement is found to have been due to the Government and not paid at the time of filing return by reason of the taxpayer's ignoring the regulations.

SECTION 250, ARTICLE 1005: Penalty for understated return. 7-20-746 A. R. M. 23

"Negligence on the part of the taxpayer, but without intent to defraud" is presumed to exist in every case in which a deduction has been made or income has been omitted in direct conflict with

the specific provisions of the law and regulations, but is not presumed to exist if the understatement may be ascribed to an error of judgment as to some matter not so concluded.

The Committee has considered the construction to be placed upon the words "negligence on the part of the taxpayer, but without intent to defraud," as used in section 250(b) of the Revenue Act of 1918.

Article 1005, Regulations 45, states that "In general, negligence is attributable to the taxpayer if he computes the tax in disregard of the instructions on the return form or otherwise incorrectly, unless he can show that his error was due to an honest misunderstanding of the facts or the law of which an average reasonable man might be capable."

Negligence may consist in the failure to ascertain the specific provisions of the law and regulations appertaining to the return of income. In the average case, the instructions contained in the form cover the information to be submitted and refer the taxpayer to the provisions of the regulations that are to be followed. If the understatement positively conflicts with these instructions, or the references contained in the instructions, a presumption exists that the taxpayer has been negligent.

Furthermore, if the taxpayer submits a return ignoring specific provisions of the law and regulations, he is presumed to have been negligent even though he is able to show that in doing so he relied upon some other person (not connected with the internal revenue service) who prepared the return or advised in its preparation.

This section places upon the taxpayer the duty of knowing and understanding such parts of the regulations as are applicable to the submission of his return. This requirement should not be carried to the extent of expecting the judgment of the taxpayer on questions involving judgment to concur exactly with the judgment of representatives at the Bureau. If the understatement is due to writing off more depreciation than is proper, in the judgment of representatives of the Bureau, or the deduction of salaries which are excessive, or similar approximations, then negligence can not be imputed to the taxpayer, unless the position taken is so unreasonable as to indicate bad faith.

It should be borne in mind that extraordinary cases may exist in which the facts may rebut the presumption of negligence. In these instances, the Committee is of the opinion that special appeals should be made by the taxpayer. It is believed that they will be so few that a ruling may be adopted that, in the first instance, the penalty may be asserted if, in direct conflict with the specific provisions of the law and regulations, a return is understated.

SECTION 250, ARTICLE 1005: Penalty for understated return. 10-20-782 O. 1008

INCOME AND PROFITS TAXES:
SECTION 3176 R. S., AS AMENDED BY THE REVENUE ACT OF 1916, AND BY THE REVENUE ACT OF 1918; SECTION 250(b) OF THE REVENUE ACT OF 1918.

"Understatement" as used in section 250(b) has particular reference to the understatement of the amount of the tax in the return. This is true whether such understatement resulted from the false or

fraudulent computation of the tax or from false or fraudulent misstatements or omissions of items of income or misstatements of items of deduction or from other false or fraudulent entries or omissions.

Section 250(b), providing for the addition as part of the tax 50 per centum of the amount of the deficiency, and not section 3176 R. S., as amended by the Revenue Act of 1918, is applicable to income and profits tax matters arising under the Revenue Act of 1918, where there is an understatement of the amount of the tax in the return and the understatement resulted from fraud with intent to evade the tax. In all other cases of false or fraudulent returns willfully made in matters arising under the Revenue Act of 1918, section 3176 Revised Statutes, as amended by that Act, is applicable.

SECTION 250, ARTICLE 1005: Penalty for understated return. 18-20-903 O. 1028

AD VALOREM PENALTIES.

Where, through fraud with intent to evade tax, an understatement of the amount of the tax in an income tax return results, the understatement is false or fraudulent and the 50 per cent of the whole amount of the deficiency is required to be added to the tax. The 5 per cent penalty provided for understatements due to negligence has no application to any part of the deficiency in such a case.

In an income tax return under the Revenue Act of 1918 a taxpayer in good faith and without any fault on his part failed to report in the return certain items of income. He also negligently failed to report certain other items of income. He also fraudulently and with intent to evade the tax failed to report certain other items of income. The result was that he made an understatement in the return of the amount of the tax due from him. Under section 250 of the Revenue Act of 1918, the question arises whether the part of the deficiency which resulted from the failure in good faith and without his fault to report the first items shall be free from penalty, whether the part of the deficiency which resulted from the negligent failure to report the second items shall be subject to the 5 per cent penalty, and whether the part which resulted from the fraudulent failure to report the third items shall be subject to the 50 per cent penalty; or whether the 50 per cent penalty attaches to the whole amount of the deficiency.

Section 250(b) of the Revenue Act of 1918 provides:

As soon as practicable after the return is filed the Commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the installments shall be recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as recomputed, the excess so paid shall be credited against the subsequent installments, and if the amount already paid exceeds the correct amount of the tax the excess shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

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.

If the understatement is false or fraudulent with intent to evade the tax, then, in lieu of the penalty provided by section 3176 of the Revised Statutes, as amended, for false or fraudulent returns willfully made, but in addition to other penalties provided by law for false or fraudulent returns there shall be added as part of the tax 50 per centum of the amount of the deficiency.

The context of section 250(b) indicates that the understatement of the amount of the tax in the return is to be dealt with as a whole. In the second sentence of the second paragraph clearly no part of the amount of the understatement—this is, the deficiency—is to be free from penalty if the return is not made in good faith or is due to any fault of the taxpayer. In other words, to be free from penalty *the return*, not a part of it, must be made in good faith. If, therefore the return is tainted with fraud or negligence, certainly it could not be held that it was "made in good faith," or was not due to any fault on the part of the taxpayer.

The third sentence of the same paragraph provides that "there shall be added as part of the tax 5 per centum of the total amount of the deficiency," provided "the understatement is due to negligence on the part of the taxpayer, but without intent to defraud." In other words, if there was intent to defraud, even though there was negligence also, the 5 per cent penalty does not attach. A greater penalty is provided for such a case. But where there was negligence but no intent to defraud the 5 per cent attaches and, by the wording of the statute, it attaches to the "total amount of the deficiency." No provision is here made for dividing up the deficiency and applying to part of it the 5 per cent penalty and to the other part no penalty at all. This sentence, read in connection with the preceding one, leaves no room for doubt. The clauses "if the return is made in good faith" and "not due to any fault" in the first sentence and the phrase "total amount of the deficiency" in the second clearly show that Congress intended that the total deficiency in cases of negligence, where there was no intent to defraud, is the basis for the 5 per cent penalty.

The third paragraph of section 250(b) provides a penalty of 50 per cent of the amount of the deficiency, not simply a part thereof, if the understatement of the amount of the tax in the return "is false or fraudulent with intent to evade the tax." Fraud resulting in an understatement makes the understatement fraudulent (Law Opinion 1008). There is nothing in the statute to indicate that Congress intended in such a case to treat the *understatement* other than as a whole, and therefore if tainted with fraud then fraudulent within the meaning of the Act. As above pointed out, the 5 per cent penalty is not applicable where there was "intent to defraud." If not applicable at all in cases of fraud, manifestly it is not applicable to any part of the deficiency in such cases. If the understatement is false or fraudulent with intent to evade tax, the amount of the deficiency, not a part of the amount, is by the statute made the basis for the 50 per cent penalty.

It is held that where, through fraud with intent to evade tax, an understatement of the amount of the tax in an income tax return under the Revenue Act of 1918 results, the understatement is false or fraudulent within the meaning of section 250(b) of the Act and that

50 per cent of the whole amount of the deficiency is required to be added to the tax. The 5 per cent penalty provided for understatements due to negligence has no application to any part of the deficiency in such a case.

SECTION 250, ARTICLE 1006: Penalty for non-payment of tax. 2-20-678 O. D. 366

Where an amended return showing additional tax liability has been filed, no interest on the additional tax will be collected unless ten days after notice and demand by the collector the amount of the additional tax assessed has not been paid, provided there appears to have been no neglect or intent to defraud upon the part of the taxpayer.

SECTION 250, ARTICLE 1006: Penalty for non-payment of tax. 7-20-747 O. 931

INCOME TAX: REVENUE ACT OF 1918, SECTION 250(e).

The provisions of section 250(e), Revenue Act of 1918, apply only to taxes imposed under the provisions of Title II, Revenue Act of 1918, except where by the provisions of some other title they are made applicable thereto.

Opinion is requested as to whether the provisions of section 250(e), Revenue Act of 1918, apply to taxes imposed under other titles of that Act, or to taxes imposed under earlier Revenue Acts.

Section 250(e), Revenue Act of 1918, is as follows:

If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, 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: *Provided*, That as to any such amount which is the subject of a bona fide claim for abatement such sum of 5 per centum shall not be added and the 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 the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be deemed sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be deemed sufficient notice of the amount due.

1. The provisions of the above-quoted subdivision are intended to apply only to taxes imposed under Title II of the Revenue Act of 1918. This is very apparent upon a consideration of the provisions of certain other titles included in that Act, namely, Titles IV, V, VI, and IX. In each of these titles express provision is made for the payment of the tax therein provided for and the amount of penalty and interest that shall be added if the tax is not paid when due. In most instances penalty and interest commence to run from the date when the tax is due and in no case is an exception made in the case of estates of insane, deceased or insolvent persons. (See Revenue Act of 1918, sections 406, 502, 504, 629, 903, and 905.) There is no more reason to suppose that the provisions of Title II, section 250(e), were intended to apply to taxes imposed under these other titles than that the penalty and forfeiture provisions of the other titles were intended to apply to Title II.

Save for Titles I, XIII, and XIV, which apply to the Act as a whole, the penalty and forfeiture provisions of each title in the Act obviously apply simply to taxes imposed under that particular title, except where expressly extended to or incorporated into the provisions of some other title. Thus, by section 336, the provisions of Title II in regard to the manner of making returns, and the payment of taxes, including penalties, are expressly made applicable to taxes imposed by Title III. Section 250(e) is thus applicable to taxes imposed under Title III of the Revenue Act of 1918, not because of any intent discoverable in its language that it should so apply but by reason of the express provisions of section 336.

2. It is urged, however, that the provisions of section 250(e), Revenue Act of 1918, were intended to apply to taxes imposed under earlier Revenue Acts.

Section 1400, Revenue Act of 1918, in subdivision (a) repeals, among others, the income tax and war income tax titles of the Revenue Acts of 1916 and 1917 respectively. Subdivision (b) then provides in part as follows:

> Such parts of Acts shall remain in force for the assessment and collection of all taxes which have accrued thereunder, and for the imposition and collection of all penalties or forfeitures which have accrued *and may accrue* in relation to any such taxes, * * *.

To hold that the provisions of section 250(e) apply to taxes imposed under the Revenue Acts of 1916 or 1917 would amount to a direct contradiction of the terms of section 1400(b) above quoted. It would not be a possible interpretation of section 250(e) to hold that part of its provisions, namely, those providing for a reduced rate of interest on bona fide claims for abatement, were intended to apply to earlier Revenue Acts and that the remainder were not. The language of the subdivision is so interrelated that either the whole must have been intended to apply to earlier Revenue Acts or no part of it. It seems clear that the latter view is the correct one. The expression "any tax" used in section 250(e), Revenue Act of 1918, is clearly intended to refer simply to any tax imposed under the provisions of Title II, Revenue Act of 1918.

A very similar question has arisen under section 250(d), Revenue Act of 1918. Law Opinion 833 holds that the five-year limitation on assessment and suit contained in that subdivision applies only to taxes due under the Revenue Act of 1918.

It is held, therefore, that the provisions of section 250(e), Revenue Act of 1918, apply only to taxes imposed under the provisions of Title II, Revenue Act of 1918, except where by the provisions of some other title they are made applicable thereto.

SECTION 250, ARTICLE 1006: Penalty for non-payment of tax. 9-20-775 O. D. 408

A taxpayer having filed his return and paid the first installment of tax is aware of his liability to pay the balance of the tax on the respective due dates, and failure to receive notice and demand for the payment of the later installments by reason of his absence from this country does not constitute a sufficient cause for waiving the penalty and interest on any installment of the tax not paid when due.

SECTION 250, ARTICLE 1006: Penalty for non-payment of tax. 14-20-837 O. D. 442

The charge of $5 required to be added to the tax in cases where it is necessary to use a warrant of distraint, is collectible not upon the issuance but upon the serving of such warrant. If the warrant is placed in the hands of the taxpayer or is read to him personally, it is considered as having been served whether payment of the tax is made at once or is deferred so that it becomes necessary to seize property of the taxpayer.

SECTION 250, ARTICLE 1006: Penalty for non-payment of tax. 17-20-876 O. 1026

INCOME TAX: PARAGRAPH E, SECTION 2 OF THE ACT OF OCTOBER 3, 1913; SECTION 9 (a) OF THE REVENUE ACT OF 1916.

Concerning the Assertion of the 5 per cent Penalty and Interest at the Rate of 1 per cent per month where Taxes are not paid in 10 days after Notice and Demand by the Collector.

Where an income tax was assessed against a person who failed to make payment when it became due, and the collector thereupon gave notice and made demand for payment, and prior to the expiration of 10 days after such notice and demand the Alien Property Custodian under the provisions of the Trading with the Enemy Act, approved October 6, 1917, took over all the property of such person, thereby rendering it impossible for him to make payment within the time required, the 5 per cent penalty and interest at the rate of 1 per centum per month do not attach.

Advice is requested whether collectors should be required to collect the 5 per cent penalty and charge interest at the rate prescribed by the statutes for failure to pay income tax when due, in cases where the property of the taxpayers has been seized by the Alien Property Custodian and they have no funds with which to liquidate their liability.

Although not so stated in the inquiry undoubtedly the outstanding assessments in the cases under consideration were made pursuant to the income tax Acts passed prior to the Revenue Act of 1918.

Paragraph E, section 2, of the Act of October 3, 1913, provides:

That all assessments shall be made by the Commissioner of Internal Revenue and all persons shall be notified of the amount for which they are respectively liable on or before the first day of June of each successive year, and said assessments shall be paid on or before the thirtieth day of June, except in cases of refusal or neglect to make such return and in cases of false or fraudulent returns, in which cases the Commissioner of Internal Revenue shall, upon the discovery thereof, at any time within three years after said return is due, make a return upon the information obtained as provided for in this section or by existing law, and the assessment made by the Commissioner of Internal Revenue thereon shall be paid by such person or persons immediately upon notification of the amount of such assessment; and to any sum or sums due and unpaid after the thirtieth day of June in any year, and for ten days after notice and demand thereof by the collector, there shall be added the sum of 5 per centum on the amount of tax unpaid, and interest at the rate of 1 per centum per month upon said tax from the time the same became due, except from the estates of insane, deceased, or insolvent persons.

Section 9(a) of the Revenue Act of 1916 provides:

That all assessments shall be made by the Commissioner of Internal Revenue and all persons shall be notified of the amount for which they are respectively

liable on or before the first day of June of each successive year, and said amounts shall be paid on or before the fifteenth day of June, excepting cases of refusal or neglect to make such return and in cases of erroneous, false or fraudulent returns, in which cases the Commissioner of Internal Revenue shall, upon the discovery thereof, at any time within three years after said return is due, or has been made, make a return upon information obtained as provided for in this title or by existing law, and the assessment made by the Commissioner of Internal Revenue thereon shall be paid by such person or persons immediately upon notification of the amount of such assessment; and to any sum or sums due and unpaid after the thirtieth day of June in any year, and for ten days after notice and demand thereof by the collector, there shall be added the sum of 5 per centum on the amount of the tax unpaid, and interest at the rate of 1 per centum per month upon said tax from the time the same became due, except from the estates of insane, deceased, or insolvent persons.

The provision quoted from the Revenue Act of 1916 is made applicable to the income tax imposed by the Revenue Act of 1917, upon individuals, by section 3 of the latter Act, and to the excess profits tax by section 212 thereof.

If the collector, after the date the tax was due for payment, gave the notice and demand, and the taxpayer did not pay within 10 days after the notice and demand, the law makes it the collector's duty to add to the amount of tax unpaid the sum of 5 per centum and interest at the rate of 1 per centum per month from the time the same became due. In other words, before the penalty and interest can be added it is essential that—

(1) The assessment must have been made.
(2) The tax must have become due for payment and remained unpaid after the due date.
(3) The collector must have thereafter given notice to and demanded payment from the taxpayer.
(4) Ten days must have elapsed from and after such notice and demand.

It is assumed from what is submitted that these essentials have been met, for otherwise it is clear the penalty and interest could not be collected. If these essentials were met the penalty and interest attach, the tax not having been paid within the 10-day limitation, even though the Alien Property Custodian thereafter, under the provisions of the Trading with the Enemy Act, approved October 6, 1917, made demand for the taxpayer's property after the expiration of the 10-day period. If, however, the demand of the Alien Property Custodian, acting as the Government's agent under authority conferred upon him by the Trading with the Enemy Act, was made prior to the expiration of the 10-day period, the case stands on a different footing. The default in payment within the time required by law was due not to the taxpayer's act or failure to act but rather to the superior force of the Government, acting through and by the Alien Property Custodian under the provisions of the statute whereby he acquired title before the 10-day period expired. The 5 per cent penalty "is imposed on the person who is liable for the taxes, because of his personal default in not paying the tax within the time required by law." *Clay* v. *Swope*, 38 Fed. 396. Failure to pay within the required time under such conditions and circumstances is not such a personal default on the part of the taxpayer as is contemplated under the sections of the income tax law quoted.

The situation is not unlike that of a case where a person can not perform his part of a contract because the other party to the contract has done or failed to do something which prevents the performance. The courts hold such a person blameless for his failure to perform under such circumstances. *William* v. *United States Bank*, 2 Pet. 96, 102; *Clearwater* v. *Meredith*, 1 Wall. 25, 39; *Dermott* v. *Jones*, 2 Wall. 1, 7; *United States* v. *Gleason*, 175 U. S. 588, 602. The situation is also strikingly similar to a case where performance of the terms of a contract is *by law* rendered impossible. The courts have in such cases held that nonperformance will be excused. *Dermott* v. *Jones*, 2 Wall. 1, 7; *United States* v. *Gleason*, 175 U. S. 588, 602.

Furthermore, the Government took over the property of the taxpayer and has all of the time had the use of it. The part of it that should be credited to the liquidation of the tax has at all times been available to the Government, and upon a proper showing made to the Alien Property Custodian, he will credit that part to the payment of the tax. Under such circumstances the Government can not be heard to say that the taxpayer failed to pay the tax.

It is held that where an income tax was assessed against a person who failed to make payment when it became due, and the collector thereupon gave notice and made demand for payment, and prior to the expiration of 10 days after such notice and demand the Alien Property Custodian, under the provisions of the Trading with the Enemy Act, approved October 6, 1917, took over all the property of such person, thereby rendering it impossible for him to make payment within the time required, the 5 per cent penalty and interest at the rate of 1 per cent per month do not attach.

SECTION 250, ARTICLE 1011: Compromise of tax cases. 23–20–990 O. D. 539

Where the Bureau has determined that no penalty is due and has rejected an offer in compromise, a notice of "special allowance" is sent to the collector, who then instructs the taxpayer to file claim for refund on Form 627.

SECTION 250, ARTICLE 1011: Compromise of tax cases.

(See 24–20–1006; sec. 219, art. 345.) Compromise of tax legally due from solvent taxpayer.

SECTION 250, ARTICLE 1011: Compromise of tax cases. 25–20–1019 Sol. Op. 7

COMPROMISE—SECTION 3229, R. S.

There is sufficient valid consideration to support the acceptance of an offer in compromise of specific penalty made by a taxpayer, even though action thereon is barred by the statute of limitations.

The offer in compromise of x dollars submitted by A in settlement of liability to specific penalty for failure to file income tax return

for the year 1914 within the time required by law, raises the question as to whether the offer can be legally accepted at this date, the cause of action for the penalty against the taxpayer being barred by the statute of limitations.

The evidence shows that under date of July 9, 1918, a revenue agent submitted a report relative to the delinquency of A and filed returns of his income for the years 1913 and 1914. The examining officer states that he is satisfied beyond a reasonable doubt that the violation was flagrant and willful. Under date of August 7, 1919, the Collector of Internal Revenue advised that A had submitted an offer in compromise of x dollars, which was reported for the taxpayer's delinquency for the year 1914 and in lieu of the specific penalty. The offer was reported on the collector's list for January, 1920, and was not received in this office in sufficient time to be considered and passed upon before March 1, 1920.

Section 1047, Revised Statutes, in part, is as follows:

> No suit or prosecution for any penalty or forfeiture, pecuniary or otherwise, accruing under the laws of the United States, shall be maintained, except in cases where it is otherwise specifically provided, unless the same is commenced within five years from the time when the penalty or forfeiture accrued. * * *

Assuming that the above statute would apply to any attempt to enforce the specific penalty against the proponent, it will be noted that the five years expired on March 1, 1920.

Offers in compromise rest upon the same legal principles as ordinary contracts. *Broughton* v. *United States*, 12 Ct. Cl. 330. There are cases holding that the acceptance of an offer relates back to the date of the offer, but it is considered the correct rule in ordinary contracts is that the date of a contract is the date of its acceptance. Williston on Contracts, vol. 1, secs. 96–97. Therefore, if the claim of the Government is entirely without any foundation at all, either in law or in equity, according to the great weight of authority, there is not sufficient consideration for the compromise. (12 C. J. 327–328.) If, on the other hand, the Government does surrender its claim, and the claim has some foundation, either in law or equity, there is sufficient consideration to support the compromise.

The only adjudicated case on the question as to whether the surrender of a claim barred by the statute of limitations is sufficient consideration to support a contract which can be found is *Taylor* v. *Weeks*, 88 N. W., 466 Mich. This case holds there is not sufficient consideration, but the court does not set out the statute involved, and it is, therefore, impossible to tell whether it is the ordinary statute with language similar to section 1047, Revised Statutes, or is a statute which extinguishes the obligation.

In the case of *Burriss* v. *Starr*, 81 S. E. 929 N. C., it was held there was sufficient consideration for a compromise, even though the subject matter could not be made the basis of an action on account of the statute of frauds. The same principle is upheld in 9 Cyc. 345.

It has been held that while a discharge in bankruptcy operates to release a bankrupt from all legal liability for a debt, there is a moral obligation which remains, and a promise to pay such a debt is sufficiently supported by that moral obligation. *Herrington* v. *Davitt*, 1 A. L. R. 1700, and notes.

Except where a statute by its terms absolutely extinguishes the debt or demand itself, the general rule is that statutes of limitation are regarded as barring the remedy only, and not as extinguishing the cause of action. 25 Cyc. 997–998.

As section 1047, Revised Statutes, is not considered as extinguishing the cause of action in this case, and as there is also a moral obligation remaining, it is held there is sufficient consideration to support the contract. While the statute has undoubtedly run, still the Government could bring its action and could prevail unless the defendant saw fit to plead the statute as a defense. It is not a question of jurisdiction, but of personal defense. 25 Cyc. 1401.

The question therefore resolves itself as to whether the proponent intended his offer to apply to the changed conditions, the statute not having run when the offer was made. The offer could be withdrawn at any time before acceptance. (Solicitor's Memorandum 1323.) The proponent is charged with knowledge of the law, and it is believed the Government is warranted in assuming that when the statute tolled and he made no effort to withdraw the offer, that the offer can be considered as a renewal thereof to meet the changed conditions, and may be properly and legally accepted.

WAYNE JOHNSON,
Solicitor of Internal Revenue.

SECTION 250, ARTICLE 1012: Assessment of tax. 15–20–857
T. D. 3000

[PRIORITY OF FEDERAL TAXES. DECISION OF COURT. SMIETANKA v. ZIBELL, UNITED STATES CIRCUIT COURT OF APPEALS, JANUARY, 1920.]

Section 3466, Revised Statutes, is in pari materia with sections 64(a) and 64(b) of the Bankruptcy Act, and to the extent that it is in conflict therewith it is superseded thereby. Therefore, no priority is given to Federal taxes except over creditors, and such taxes are not entitled to priority over the administration expenses of the bankruptcy proceedings.

The appended decision of the United States Circuit Court of Appeals for the Seventh Circuit in the case of *Smietanka* v. *Zibell* is published for the information of internal revenue officers and others concerned:

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT—
No. 2757.

In the matter of Eli I. Jacobson, bankrupt. *Julius F. Smietanka, Collector of Internal Revenue*, v. *William F. Zibell, Receiver of Estate in Bankruptcy.*

EVANS, C. J.: Contending that its claim for taxes should be paid before the costs and expenses of administering the insolvent estate of Eli I. Jacobson, a bankrupt, the Government relies upon section 3466, Revised Statutes, and sections 64(a) and 64(b) of the Bankruptcy Act to support its position. These three sections read:

Section 3466, Revised Statutes:

Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or adminis-

trators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority hereby established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which act of bankruptcy is committed.

Bankruptcy Act, section 64(a):

The court shall order the trustee to pay all taxes legally due and owing by the bankrupt to the United States, State, county, district, or municipality in advance of the payment of dividends to creditors, and upon filing the receipts of the proper public officers for such payment he shall be credited with the amount thereof, and in case any question arises as to the amount or legality of any such tax the same shall be heard and determined by the court.

Section 64(b):

The debts to have priority, except as herein provided, and to be paid in full out of bankrupt estates, and the order of payment shall be (1) the actual and necessary cost of preserving the estate subsequent to filing the petitions; (2) the filing fees paid by creditors in involuntary cases; * * * (3) the cost of administration, including the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the petitioning creditors in involuntary cases, to the bankrupt in involuntary cases while performing the duties herein prescribed, and to the bankrupt in voluntary cases, as the court may allow; (4) wages due to workmen, clerks, traveling or city salesmen, or servants which have been earned within three months before the date of the commencement of proceedings, not to exceed $300 to each claimant; and (5) debts owing to any person who by the laws of the States or the United States is entitled to priority.

The first section quoted is a general statute. It existed prior to the passage of the Bankruptcy Act and was partly superseded by that Act. In other words, sections 64(a) and 64(b) of the Bankruptcy Act are in pari materia with section 3466. Debts due the United States other than taxes are not given the same protection in the two cited sections of the Bankruptcy Act as existed under the general statute, section 3466, or under the Bankruptcy Act of 1867. This is clearly brought out by Mr. Justice McKenna in *Guarantee Title & Trust Co., trustee*, v. *Title Guaranty & Surety Co.*, 224 U. S., 152. Speaking of the various Bankruptcy Acts the court says (p. 158):

The Bankruptcy Act of 1867, as we have seen, provided priority, first, for the payment of expenses, and, second, of "all debts due to the United States, and all taxes and assessments under the laws thereof." The priority, therefore, given by the Bankruptcy Act was coextensive with the priority given by the statute of 1797. In other words, to repeat, there was a reaffirmation by the Bankruptcy Act of the statute 1797. But there is not such affirmation by the Bankruptcy Act of 1898 of that statute, which still exists, as we have said as section 3466 of the Revised Statutes, supra. There is a change in provisions, and we come to the question if there is a change of purpose.

Proceeding further, the court says (p. 159):

It will be seen, therefore, that by the statute of 1797 (now section 3466) and section 5101 of the Revised Statutes all debts due to the United States were expressly given priority to the wages due any operative, clerk, or house servant. A different order is prescribed by the Act of 1898, and something more. Labor claims are given priority, and it is provided that debts having priority shall be paid in full. The only exception is "taxes legally due and owing by the bankrupt to the United States, State, county, district, or municipality." These were civil obligations, not personal conventions, and preference was given to them, but as to debts we must assume a change of purpose in the change of order. And we can not say that it was inadvertent. The Act takes into consideration, we think, the whole range of indebtedness of the bankrupt, national, State, and individual, and assigns the order of payment.

We have quoted thus freely to justify the elimination from this case—that is, so far as it relates to taxes as distinguished from other debts—of section 3466, Revised Statutes, confidently relied upon by counsel for the Government. And his chief citations, In re Weiss, 159 Fed., 295; In re Prince, 131 Fed., 546; In re Cramond, 145 Fed., 966; *City of Chattanooga* v. *Hill*, 139 Fed., 600, were all decided prior to the decision in *Guarantee Title Insurance Co.* v. *Title Guaranty & Surety Co.*

If petitioner's claim is entitled to priority, it must then be by virtue of section 64(a) of the Bankruptcy Act. Its claim being for a tax is entitled to the preference and priority which this section provides. But what is the priority thus created? Clearly priority over claims of other "creditors." This section directs payment of these taxes "in advance of the payment of dividends to creditors." "Creditors" of the bankrupt are not entitled to dividends until the taxes are paid. No recognition of priority in favor of taxes appears, except as to creditors. Who, then, are the "creditors" of whose claims Congress was speaking? Having defined the term "creditor" by a previous section, it was no doubt making use of its own definition, in thus using the term in section 64(a). "Creditors shall include anyone who owns a demand provable in bankruptcy." Thus Congress by section 1, subdivision 9, of the Act comprehensively designates the class known as creditors, the class whose claims are subject to the claims of "the United States, State, county, district, or municipality" for taxes. By no stretch of the definition of this term "creditor" could it be construed to include clerk, trustee, referee, or anyone whose relation with the bankrupt or the bankrupt's estate began subsequent to the filing of the petition in bankruptcy.

Moreover, it is hardly conceivable that the Congress should confer upon the district court power to administer bankrupt estates, to sequester and preserve property, perishable as well as losable, and yet deny to the court the right to protect its officers in the performance of their duties, notwithstanding such performance of duties and such administration of the insolvent estate is for the benefit of the taxing powers even more than it is for the general creditors. In re Halsey, 179 Fed., 321.

The decree is affirmed.

SECTION 250, ARTICLE 1013: Declaration of termination of taxable period. 4–20–709 O. D. 385

In the case of an alien leaving the country, if his name does not appear on any Form 1042 filed by his employer for the years 1916, 1917, 1918, or 1919, the collector may, for the purpose of determining the alien's tax liability, require the employer to furnish statements of the alien's earnings for the years in question under section 3173 of the Revised Statutes as amended.

SECTION 250, ARTICLE 1013: Declaration of termination of taxable period. 16–20–867 O. D. 468
(Also Section 217, Article 312.)

The status of an alien leaving the United States during the taxable year is determined by his status on the last day of his taxable period.

The taxable period is the interval between January 1 and the last day of the month preceding his departure. If the alien had formed no intention of leaving the United States by such date he will be taxed as a resident alien. If, however, his intention to depart was formed prior to the last day of the month preceding departure, he will be taxed as a nonresident alien for such period. In either case the alien is entitled to the full exemption and credit for dependents that he would have been entitled to had his return been filed for the full taxable year. If the absence of a resident alien is to be only temporary, he will not lose his status as resident by reason of such absence.

SECTION 250, ARTICLE 1013: Declaration of termination of taxable period. 19-20-923 O. D. 500

Consular receipts showing payment of United States income taxes through a United States consulate by citizens of this country residing abroad will be accepted by revenue agents at ports of embarkation as evidence of satisfaction of income tax obligations in the case of departure of such citizens who are temporarily in this country.

SECTION 252.—REFUNDS.

SECTION 252, ARTICLE 1032: Claims for abatement of taxes erroneously assessed.

(See 23-20-984; sec. 213(a), art 52.) Claim for abatement of excess tax assessed for 1916, where assessment of additional tax due for 1915 is barred by statute of limitations.

SECTION 252, ARTICLE 1034: Claims for credit of taxes erroneously collected. 1-20-662 O. 974

UNDISTRIBUTED NET INCOME TAX.

An overpayment of undistributed net income tax, imposed by section 10(b) of the Revenue Act of 1916, as amended by the Revenue Act of 1917, may be credited against an additional amount of income tax due from the taxpayer within the limitations imposed by section 252 of the Revenue Act of 1918.

Section 252 of the Revenue Act of 1919 provides:

That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, * * * the Act of October 3, 1913, * * * 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 * * * 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 any excess shall be immediately refunded to the taxpayer; * * *

Section 10(b) of the Revenue Act of 1916, added by section 1206 of the Revenue Act of 1917, provides:

In addition to the income tax imposed by subdivision (a) of this section there shall be levied, assessed, collected, and paid annually an additional tax of

10 per centum upon the amount remaining undistributed six months after the end of each calendar or fiscal year of the total net income of every corporation, joint-stock company, or association, or insurance company, received during the year, * * *

Section 10(a) of the Revenue Act of 1916, as amended, imposes a tax upon the total net income of corporations. This net income is obtained by excluding or deducting from the total gross income certain items. Section 10(b) of the Act, as amended, imposes an "additional tax." The inference is that this tax is also an income tax. It is imposed by the same section of the law as imposes the tax upon the total net income of corporations and is imposed under Title I of the 1916 Act, as amended, which bears the caption "Income Tax." It is imposed not upon the total net income but upon such net income reduced by such amount as is distributed or "is actually invested and employed in the business or is retained for employment in the reasonable requirements of the business or is invested in obligations of the United States issued after September first, nineteen hundred and seventeen." Since the undistributed net income tax is imposed on a part of the net income of the taxable year, it is an income tax within the meaning of section 252 of the Revenue Act of 1918.

It is therefore held that an overpayment of undistributed net income tax (imposed by section 10(b) of the Revenue Act of 1916, as amended by the Revenue Act of 1917) may be credited against an additional amount of income tax due from the taxpayer within the limitations imposed by section 252 of the Revenue Act of 1918.

SECTION 252, ARTICLE 1034: Claims for credit of taxes erroneously collected. 11-20-789A M. 2429

The Supreme Court has handed down a decision in the case of *Eisner* v. *Macomber*, which in substance is as follows:

A true stock dividend made lawfully and in good faith by a corporation, either against profits invested in lands, buildings, equipment, or working assets of a corporation, or against accumulated and undivided profits, is not taxable as income to the shareholder recipient, it being held that to tax such stock dividends would be to tax property without apportionment in violation of the provisions of article 1, section 2, clause 3, and article 1, section 9, clause 4 of the Constitution, notwithstanding the sixteenth amendment, there being no realization of profit taxable as income until a sale of shares is made.

The Bureau has telegraphed to the collectors of internal revenue as follows:

Claims for credit against first installment March 15 on account of tax paid in prior years on stock dividends may be accepted but must not be permitted to reduce payment on March 15 installment unless claim on Form 47A is filed setting forth full details of dividends received and taxes paid thereon, and a statement of all details of any subsequent sale of shares received as a stock dividend and unless claim is accompanied by statements from the corporations which distributed dividends as to amount distributed to taxpayer and years in which profits distributed were earned.

In filing returns for prior years taxpayers reported dividends received, including both cash and stock dividends, without segrega-

tion. It will therefore be necessary for the department to have specific information, verified by the corporations declaring the dividends, as to the amount of dividends distributed to each taxpayer, the year in which the profits distributed were earned, a statement disclosing all details of subsequent sales of the shares in order that the amount of credit allowable and the validity of the claim may be correctly and justly determined.

In accordance with this the taxpayer should present to the collector formally a claim for credit for any overpayment of taxes in prior years on the regular form for that purpose (Form 47A) and on this form must be set forth the full details of dividends received and taxes paid thereon. This claim must be accompanied by a statement or certificate from the corporation distributing the dividends, showing the amount distributed to the taxpayer and the years in which profits distributed were earned.

Taxpayers on complying with these requirements will be permitted by the collectors to credit the amounts due them against any installment of taxes remaining unpaid. In case the credit to which the taxpayer is entitled exceeds the amount of taxes remaining unpaid, a claim for refund of the difference may be filed.

SECTION 252, ARTICLE 1034: Claims for credit of taxes erroneously collected. 11-20-789B M. 2436

A claim for credit on Form 47A for payment of tax on stock dividends is to be accepted as a suspension of immediate collection of tax due only—

(1) Against income or income and excess profits taxes due and unpaid.

(2) If amount claimed as a credit does not exceed the amount of tax collected on the stock dividend less any additional tax due and unpaid upon the sale of stock received as a dividend or stock upon which the dividend was declared. (The basis of determining the gain or loss upon sale of stock is stated in Regulations 45, article 1547, paragraphs 1 and 2. That article provides that the cost of each share of stock is the quotient of the cost of the old stock divided by the number of old and new shares added together.)

(3) When accompanied by an affidavit of the taxpayer (supported by statements from the corporation which distributed the dividends as to the amount distributed to the taxpayer and years in which the profits distributed were earned) covering the following information:

(*a*) Whether the dividend consists of stock of the corporation distributing the dividend to the taxpayer, or of stock of another corporation acquired by the distributor.

(*b*) The name of each corporation declaring, the declaration of, and the date of receipt by the taxpayer of, the stock dividends, the tax on which was paid and is covered by the claim.

(*c*) The year in which the stock dividend was included in the taxpayer's return of income.

(*d*) The number of shares the taxpayer received and the value placed upon the dividend in the return. (If no sale of stock was made, the taxpayer need not furnish the following information.)

(*e*) If any sale has been made of stock of the corporation declaring the dividends, whether the stock be that acquired by a dividend, or upon which the dividend was declared, state—

(1) The number of shares sold.

(2) The selling price.

(3) The date or dates of sale.

(4) The portion, if any, of the selling price included as taxable profit in the return of net income for the year the sale was made and the item in the return under which the amount was reported.

(*f*) State how many shares of stock the taxpayer owned at the time he received the first stock dividend; how much that stock cost the taxpayer and the date the stock was acquired. (If acquired prior to March 1, 1913, state its value on that date and manner of determining the value.)

(*g*) State separately the dates from March 1, 1913, upon which you received stock dividends, the number of shares received on each date, and the names of the corporations distributing the dividends.

The receipt or canceled check covering the payment of tax involved in the claim should be attached to the claim.

SECTION 252, ARTICLE 1034: Claims for credit of taxes erroneously collected. 15–20–854 O. D. 457

(Also Section 330, Article 933.)

Returns for 1918 were filed for a partnership and its members in accordance with the Revenue Act of 1917, prior to the passage of the Revenue Act of 1918, and tax paid accordingly. The partnership was incorporated prior to July 1, 1919, and elected to be taxed as a corporation under the provisions of paragraph 3, section 330, Revenue Act of 1918. Amended returns for 1918 showing overpayment of tax were filed by the partners.

There is no provision in the law whereby either the tax paid by the partnership or any excess tax paid by the partners may be credited against any tax liability of the successor corporation for any year. Remedy may be sought only by the partnership and the individual members thereof filing claims for the refunding of any excess tax paid.

SECTION 252, ARTICLE 1034: Claims for credit of taxes erroneously collected. 19–20–924 A. R. M. 46

Advice has been requested as to the course to be pursued in view of the apparent conflict between language used in Law Opinion 957 (p. 256, Cumulative Bulletin, December, 1919) and articles 1034 and 1035 of Regulations 45 as to the proper construction of section 252 of the Revenue Act of 1918 relating to credits for taxes overpaid for a previous year.

The Committee is of the opinion that the conflict is more apparent than real and grows out of a confusion of ideas as to the legal and practical effect of a credit and claim for credit.

Income taxes are assessed for specified periods and may be abated only if illegally or erroneously assessed; that is to say, in ordinary cases if the amount assessed is in excess of the correct amount due

from the taxpayer. Manifestly the fact that the taxpayer has overpaid his taxes for a previous year can have no effect upon the amount of tax for which he is liable for a different year. Consequently, prior to the passage of the Act of 1918, when such conditions existed the only course which the office and the taxpayer could pursue was to collect the present amount in full and permit the taxpayer to file a claim for refund of any amount overpaid. Congress, recognizing the injustice and hardship frequently involved in such an awkward procedure, provided for crediting the amount of any previous overpayment against the taxes presently due. Such credit, when given, has the force and effect of an order of abatement and wipes out and cancels the assessment *pro tanto*. Clearly such a credit can not be made until the facts have been carefully examined and the validity of the credit approved by the Commissioner. That is not to say, however, that a claim for credit has no effect until approved. The *claim* for credit may have precisely the same effect as a *claim* for abatement; that is, by forbearance of the collector it may suspend collection until it is acted upon by the Commissioner. If approved, credit is then given relieving both the collector and the taxpayer from any further liability. If rejected, interest is to be paid upon the amount suspended from the time it was due.

This view of the law appears to be entirely consistent with its language and also with the purpose which it was believed Congress had in mind; that is to say, relief to the taxpayer from being required to pay into the Treasury amounts, possibly large, at the same time that he is making a bona fide claim that other amounts are due him. As held in Law Opinion 957, it does not prevent the collector, if he so desires, from proceeding to collect at once just as he may do in the case of an abatement claim filed, but leaves it optional with him to suspend collection until such time as credit is given relieving both him and the taxpayer.

SECTION 253.—PENALTIES.

SECTION 253, ARTICLE 1041: Specific penalties. 22–20–977
(Also Section 250, Article 1004.) O. D. 530

ACT OF OCTOBER 3, 1913.

Where delinquent individual returns for the taxable year 1914 have been filed after the expiration of the three-year period of limitation, specific and ad valorem penalties will not be asserted. If the taxpayers signed the delinquent returns it will not be necessary to secure waivers for the purpose of assessing the taxes.

SECTION 256.—INFORMATION AT SOURCE.

SECTION 256, ARTICLE 1071: Return of information as to payments of $1,000. 12–20–800 O. D. 416

Fees paid by a corporation for professional services should be included in returns of information in cases where amounts paid to any individual or partnership during a calendar year equal or exceed one thousand dollars.

SECTION 256, ARTICLE 1071: Return of information as to payments of $1,000. 13–20–818 O. D. 428

Actual amounts of $1,000 or more paid, or credited and made available during the calendar year should be reported in returns of information on Forms 1099, revised, and 1096, revised.

SECTION 256, ARTICLE 1071: Return of information as to payments of $1,000. 16–20–868 O. D. 469
(Also Section 240, Article 632.)

Corporations which are affiliated within the meaning of section 240 of the Revenue Act of 1918 are required to make a consolidated return of net income and invested capital, but they will not be permitted to file a consolidated return of information at the source. Each corporation must file a separate return of information as required by section 256.

SECTION 256, ARTICLE 1071: Return of information as to payments of $1,000. 16–20–869 O. D. 470

A department of municipal government is required to file a return of information as provided in section 256 of the Revenue Act of 1918, showing payments of fixed or determinable gains, profits, and income of $1,000 or over in any taxable year, excluding from the return, however, payments made as salary or wages to officials or employees of a State of political subdivision thereof, and payments of interest on the obligations of a State or political subdivision thereof.

SECTION 256, ARTICLE 1072: Return of information as to payments to employees. 6–20–733 O. D. 401

In executing Form 1099, an employer who is required to withhold tax from an employee under a State income tax law, should report on such form the amount of the salary paid to the employee plus the amount of the tax withheld. The employee should report the same amount in his personal return on Form 1040 or Form 1040A as the case may be.

SECTION 256, ARTICLE 1078: Ownership certificates for foreign items.

(See 21–20–958; sec. 221, art. 364.) Schedule of ownership certificates required in collecting income from various classes of securities.

SECTION 256, ARTICLE 1078: Ownership certificates for foreign items. 25–20–1020 T. D. 3031

Regulations 45 are amended by amplifying article 1078 so as to read as follows:

ART. 1078. *Ownership certificates for foreign items.*—(*a*) When bonds of foreign countries, or bonds or stocks of nonresident foreign corporations, are

owned by citizens or residents of the United States, individual or fiduciary, by domestic or resident foreign corporations, or partnerships, or by personal-service corporations, ownership certificate Form 1001A, revised, shall be executed by the actual owner or by his duly authorized agent when presenting the item for collection, whether such item is a dividend or an interest payment, except in the case of a foreign country or a foreign corporation having a fiscal agent or a paying agent in this country and issuing bonds which contain a tax-free covenant clause. In such a case the fiscal agent or paying agent is required to withhold the normal tax of 2 per cent from the interest on such bonds and ownership certificate Form 1000, revised, modified to show the name and address of the fiscal agent or the paying agent, should be used, unless the owner (if so entitled) desires to claim exemption, in which case Form 1001A, revised, should be filed. (*b*) When such foreign bonds or stocks are owned by nonresident alien individuals, corporations, or partnerships, ownership certificate Form 1001A, revised, shall be used on behalf of such owners by any responsible bank or banker, either foreign or domestic, having knowledge of such ownership. In such a case the bank or banker need not fill in the names of the owners.

SECTION 256, ARTICLE 1078(a): Foreign items presented for collection unaccompanied by ownership certificates. 25–20–1021 T. D. 3030

Regulations 45 are amended by inserting immediately after article 1078 an article which will be known as article 1078(a), as follows:

ART. 1078(a). *Foreign items presented for collection unaccompanied by ownership certificates.*—If the foreign item is an interest coupon detached from bonds containing a tax-free covenant clause, issued by a foreign country or corporation having a paying agent in the United States, an affidavit and ownership certificate, Form 1000, revised, shall be furnished as provided in article 368.

In the case of other foreign items which are received unaccompanied by an ownership certificate and the owner is unknown, an affidavit shall be required of the payee, showing the name and address of the payee, the name and address of the debtor organization, the date of the dividend check or the maturity of the interest coupon, the name and address of the person from whom the dividend check or interest coupon was received, and a statement that the owner of the securities is unknown to the payee. The first bank receiving such foreign item shall prepare a certificate of ownership, Form 1001A, revised, crossing out the word "owner" and substituting therefor the word "payee." The first bank shall stamp or write across the face of the certificate "affidavit furnished," adding the name of the bank. Thereupon the affidavit and certificate shall be forwarded to the Commissioner as provided in article 1079.

SECTION 257.—RETURNS TO BE PUBLIC RECORDS.

SECTION 257, ARTICLE 1091: Inspection of returns. 4–20–710 T. D. 2961

Regulations governing the inspection of returns of individuals, partnerships, corporations, associations, joint-stock companies, and insurance companies made pursuant to the requirements of section 2 of the Tariff Act of October 3, 1913; Title I of the Revenue Act of 1916; Title II of the Revenue Act of 1917; and Titles II and III and section 1000, Title X, of the Revenue Act of 1918. Former regulations bearing on the same subject superseded.

Section 2 of the Tariff Act of October 3, 1913, imposes an income tax on individuals, corporations, joint-stock companies or associations, and insurance companies, and paragraph G(d) of said section provides:

When the assessment shall be made, as provided in this section, the returns, together with any corrections thereof which may have been made by the Com-

missioner, shall be filed in the office of the Commissioner of Internal Revenue and shall constitute public records and be open to inspection as such: *Provided*, That any and all such returns shall be open to inspection only upon the order of the President, under rules and regulations to be prescribed by the Secretary of the Treasury and approved by the President. * * *

Title I of the Revenue Act of 1916 imposes an income tax on individuals, corporations, joint-stock companies or associations, and insurance companies, and section 14(b) of said title provides:

When the assessment shall be made, as provided in this title, the returns, together with any corrections thereof which may have been made by the Commissioner, shall be filed in the office of the Commissioner of Internal Revenue and shall constitute public records and be open to inspection as such: *Provided*, That any and all such returns shall be open to inspection only upon order of the President, under rules and regulations to be prescribed by the Secretary of the Treasury and approved by the President. * * *

Title II of the Revenue Act of 1917 imposes a war excess profits tax on individuals, partnerships, corporations, joint-stock companies or associations, and insurance companies, and section 212 of said title provides:

That all administrative, special, and general provisons of law, including the laws in relation to the assessment, remission, collection, and refund of internal revenue taxes not heretofore specifically repealed and not inconsistent with the provisions of this title are hereby extended and made applicable to all the provisions of this title and to the tax herein imposed, and all provisions of Title I of such Act of September eighth, nineteen hundred and sixteen, as amended by this Act, relating to returns and payment of the tax therein imposed, including penalties, are hereby made applicable to the tax imposed by this title.

Title II of the Revenue Act of 1918 imposes an income tax on individuals, associations, joint-stock companies, and insurance companies, and section 257 of said title 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. * * *

Title III of the Revenue Act of 1918 imposes a war profits and excess profits tax on corporations, associations, joint-stock companies, and insurance companies, in addition to other taxes imposed by the Act, and section 336 of said title provides:

That every corporation, not exempt under section 304, shall make a return for the purpose of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places, in the same manner and subject to the same conditions as is provided in the case of returns and payment of income tax by corporations for the purposes of Title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

Section 1000, Title X, of the Revenue Act of 1918 imposes on corporations a special excise tax with respect to carrying on or doing business, and subdivision (d) of said section provides:

Section 257 shall apply to all returns filed with the Commissioner for purposes of the tax imposed by this section.

Pursuant to these provisions of law the President orders that returns of individuals, partnerships, associations, joint-stock companies, and insurance companies filed under the provisions of section 2 of the Tariff Act of October 3, 1913, Title I of the Revenue Act of 1916, Title II of the Revenue Act of 1917, and Titles II and III and section

1000, Title X, of the Revenue Act of 1918 or under laws hereafter enacted in substitution or amendment of the income tax or capital stock tax provisions thereof and not inconsistent herewith shall be open to inspection in accordance and upon compliance with the following rules and regulations:

1. These regulations deal only with *inspection* of returns, as the statutes expressly require the approval of the President of regulations on this subject. Other uses to which returns may be lawfully put, without action by the President, are not covered by these regulations.

2. The word "corporation" when used alone herein shall, unless otherwise indicated, include corporations, associations, joint-stock companies, and insurance companies. The word "return" when so used shall, unless otherwise indicated, include income and profits tax returns; and also special excise tax returns of corporations filed pursuant to section 1000, Title X, of the Revenue Act of 1918.

3. Written statements filed with the Commissioner of Internal Revenue designed to be supplemental to and to become a part of tax returns shall be subject to the same rules and regulations as to inspection as are the tax returns themselves.

4. Except as hereinafter specifically provided, the Commissioner of Internal Revenue may, in his discretion, upon written application setting forth fully the reasons for the request, grant permission for the inspection of returns in accordance with these regulations. The application will be considered by the Commissioner and a decision reached by him whether the applicant has met the conditions imposed by these regulations and whether the reasons advanced for permission to inspect are sufficient to permit the inspection. Such written application is not required of the officers and employees of the Treasury Department whose official duties require inspection of a return, or of the Solicitor of Internal Revenue.

5. The return of an individual shall be open to inspection as follows:

(*a*) By the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; (*b*) by the person who made the return, or by his duly constituted attorney in fact; (*c*) by the administrator, executor, or trustee of the taxpayer's estate, or by the duly constituted attorney in fact of such administrator, executor, or trustee, where the maker of the return has died; and (*d*) in the discretion of the Commissioner of Internal Revenue, by one of the heirs at law or next of kin of such deceased person upon showing that he has a material interest which will be affected by information contained in the return.

6. A joint return of a husband and wife shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection, and by the Solicitor of Internal Revenue; and (*b*) by either spouse for whom the return was made, or his or her duly constituted attorney, upon satisfactory evidence of such relationship being furnished.

7. The return of a partnership shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; and (*b*) by any individual (or his duly constituted attorney in fact, or legal representative) who was a member of such partnership during any part of the time covered by the return, upon satisfactory evidence of such fact being furnished.

8. The return of a corporation shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; (*b*) upon satisfactory evidence of identity and official position, by the president, vice president, secretary, or treasurer of such corporation or, if none, its principal officer; and (*c*) by a stockholder of such corporation as provided in paragraph 9 hereof.

9. A stockholder of record owning one per centum or more of the stock of the outstanding stock of a corporation may be permitted to inspect its return. Such permission will only be granted upon an application in writing to the Commissioner of Internal Revenue accompanied by an affidavit showing applicant's address, the name of the corporation, the period of time covered by the return he desires to inspect, and a certificate from the officials of the corporation or other satisfactory evidence showing the amount of the corporation's outstanding capital stock, the number of shares owned by the applicant, the date when such stock was acquired, and satisfactory proof of identity. This

privilege of inspection is personal and will be granted only to the stockholder. This rule has no application to the return of a corporation filed pursuant to the Revenue Act of 1918; specific provision, independent of Presidential regulation, being made in that act for inspection by a stockholder of a return of a corporation filed thereunder (second proviso of section 257).

10. When the head of an executive department (other than the Treasury Department), or of any other United States Government establishment, desires to inspect or to have some other officer or employee of his branch of the service inspect a return in connection with some matter officially before him, the inspection may, in the discretion of the Secretary of the Treasury, be permitted upon written application to him by the head of such executive department or other Government establishment. The application must be signed by such head and must show in detail why the inspection is desired, the name and address of the taxpayer who made the return, and the name and official designation of the one it is desired shall inspect the return. When the head of a bureau or office in the Treasury Department, not a part of the Internal Revenue Bureau, desires to inspect a return in connection with some matter officially before him, other than an income, profits tax, or corporation excise tax matter, the inspection may, in the discretion of the Secretary, be permitted upon written application to him by the head of such bureau or office showing in detail why the inspection is desired. The reasons submitted for permission to inspect as provided in this paragraph shall be considered by the Secretary and a decision reached by him whether the reasons are sufficient to permit the inspection.

11. When it becomes necessary for the department to furnish returns or copies thereof for use in legal proceedings, inspection of such returns or copies that necessarily results from such use is permitted.

12. Except as provided in paragraph 11 returns may be inspected only in the office of the Commissioner of Internal Revenue, Washington, District of Columbia.

13. A person who, under these regulations, is permitted to inspect a return may make and take copy thereof or a memorandum of data contained therein.

14. By section 3167, Revised Statutes, as amended by the Revenue Act of 1918, it is made a misdemeanor 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, which misdemeanor is punishable 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, by dismissal from office or discharge from employment.

15. All former regulations bearing on the subject of inspection of returns are hereby superseded.

16. These regulations shall remain in force until expressly withdrawn or overruled.

CARTER GLASS,
Secretary of the Treasury.

Approved:
WOODROW WILSON,
The White House, 7 January, 1920.

SECTION 257, ARTICLE 1091: Inspection of returns. 4–20–711 T. D. 2962

Regulations governing the furnishing of copies of income returns; the giving to State officials access to income returns of corporations, associations, joint-stock companies, and insurance companies; the examination by a stockholder of the annual income returns of a corporation made pursuant to Titles II and III and section 1000, Title X, of the Revenue Act of 1918.

I. Furnishing of copies of income returns.

No specific provision is made in the statutes for furnishing a copy of an income return to anyone. Authority to permit inspection does not carry with it authority to furnish a copy. Implied authority to furnish a copy is contained in several provisions of law constituting

returns public records, and in sections 161 and 251, Revised Statutes, which confer upon the Secretary of the Treasury broad power to make rules and regulations concerning "custody, use, and preservation of the records, papers, and property" of the department and the enforcement of the internal revenue laws. Because of the provisions contained in section 3167, Revised Statutes, as amended by the Revenue Act of 1918, making it unlawful for any 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 also 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," a copy of an income return can not be furnished, except as provided by law, to anyone except the person or persons who made the return. Furnishing the maker with a copy of his return is not a divulging of information contained therein to any person, within the meaning of section 3167, Revised Statutes, as amended. There are numerous provisions in the Statutes constituting the doing or failure to do certain things offenses against the United States, and providing for collecting unpaid taxes by suits in court, and for bringing suits to recover taxes and penalties wrongfully collected. These provisions would be of no avail were it held that the returns themselves, or certified copies thereof provided for in section 882, Revised Statutes, could not be used by the Government as evidence in such litigation or in preparation for same. Manifestly Congress did not, when it enacted section 3167, Revised Statutes, intend to defeat prosecution and suits in court for which it has specifically provided.

Income returns filed with the department are public records of the department, and public records in the Treasury Department are of right available as evidence in litigation in court unless there is some statute making it unlawful to use them as such. *Winn* v. *Patterson*, 9 Pet. 663, 677; *Evanston* v. *Gunn*, 99 U. S. 660; 17 Cyc. 306; *Williams* v. *Conger*, 125 U. S. 397, 410; *Iron Silver Min. Co.* v. *Campbell*, 135 U. S. 286, 298; *Oakes* v. *United States*, 174 U. S. 778; *Texas, etc., Ry. Co.* v. *Swearingen*, 196 U. S. 51, 60. As therefore the use of income returns or copies thereof in connection with litigation in court, where the United States Government is interested in the result, is provided for by law, such returns or copies may be furnished for such use without a violation of the provisions of section 3167, Revised Statutes, as amended.

The following rules and regulations are therefore prescribed:

1. The original income return of an individual, partnership, corporation, association, joint stock company, insurance company, or fiduciary, or a copy thereof may be furnished by the Commissioner of Internal Revenue to a United States attorney for use as evidence before a United States grand jury or in litigation in any court where the United States is interested in the result, or for use in the preparation for such litigation, or to any attorney connected with the Department of Justice designated by the Attorney General to handle such

matters if and when the Attorney General states to the Commissioner in writing that such attorney is so designated. When an income return or copy thereof is thus furnished, it must be limited in use to the purpose for which it is furnished and is under no conditions to be made public except where publicity necessarily results from such use. In case the original return is necessary, it shall be placed in evidence by the Commissioner of Internal Revenue or by some other officer or employee of the Internal Revenue Bureau designated by the Commissioner for that purpose, and after it has been placed in evidence it shall be returned to the files in the Office of the Commissioner in Washington. An original return will be furnished only in exceptional cases, and then only when it is made to appear that the ends of justice may otherwise be defeated. Neither the original nor a copy of an income return desired for use in litigation in court where the United States Government is not interested in the result and where such use might result in making public the information contained therein will be furnished, except as otherwise provided in the next succeeding paragraph.

2. A copy of an income return may be furnished by the Commissioner of Internal Revenue to the person who made the return or to his duly constituted attorney, or if the person is deceased, to his executor or administrator; or if the entity is in the hands of a receiver, trustee in bankruptcy, guardian or similar legal custodian, to the receiver, trustee or other similar custodian upon written application for same accompanied by satisfactory evidence that the applicant comes within this provision. "The person who made the return" as herein used refers in the case of an individual return to the individual whose return is desired, and in the case of a return to a corporation, association, joint-stock company, insurance company or fiduciary to the corporation, association, joint-stock company or fiduciary, a copy of whose return is desired. A corporation may also designate by proper action of its board of directors the officer or individual to whom a copy of a return made by the corporation may be furnished, and upon sufficient evidence of such action and of the identity of the officer or individual, a copy may be furnished to such person. A copy of a partnership income return will be furnished to the partners only in case all the partners join in the request therefor, it matters not what particular partner or officer of the partnership made the return. If the partnership has been dissolved the members surviving may be furnished a copy if all the members surviving join in the request.

3. All former regulations bearing on the subjects herein covered are hereby superseded.

II. Giving to State officials access to income returns of corporations, associations, joint-stock companies, and insurance companies.

Section 2 of the Tariff Act of October 3, 1913, imposes an income tax on corporations, joint-stock companies or associations, and insurance companies, and requires them to file income returns. Paragraph G (d) of said section provides among other things:

> That the proper officers of any State imposing a general income tax may, upon the request of the governor thereof, have access to said returns or to an abstract thereof, showing the name and income of each such corporation, joint stock company, association, or insurance company, at such times and in such manner as the Secretary of the Treasury may prescribe.

Title I of the Revenue Act of 1916 imposes an income tax on corporations, joint stock companies or associations, and insurance companies, and requires them to file income returns. Section 14(b) of said title provides among other things:

That the proper officers of any State imposing a general income tax may, upon the request of the governor thereof, have access to said returns or to an abstract thereof, showing the name and income of each such corporation, joint-stock company or association, or insurance company, at such times and in such manner as the Secretary of the Treasury may prescribe.

Title II of the Revenue Act of 1917 imposes a war excess profits tax on corporations, joint-stock companies or associations, and insurance companies, and section 212 of said title provides:

That all administrative, special, and general provisions of law, including the laws in relation to the assessment, remission, collection, and refund of internal revenue taxes not heretofore specifically repealed, and not inconsistent with the provisions of this title are hereby extended and made applicable to all the provisions of this title and to the tax herein imposed, and all provisions of Title I of such Act of September 8, 1916, as amended by this Act, relating to returns and payment of the tax therein imposed, including penalties, are hereby made applicable to the tax imposed by this title.

Title II of the Revenue Act of 1918 imposes an income tax on corporations, associations, joint-stock companies, and insurance companies, and requires them to file income returns. Section 257 of said title provides among other things:

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.

Section 1 of Title I of said Revenue Act of 1918 provides:

That when used in this Act * * * the term "corporation" includes associations, joint-stock companies, and insurance companies.

Title III of the Revenue Act of 1918 imposes a war profits and excess profits tax on corporations, associations, joint-stock companies, and insurance companies, in addition to other taxes imposed by the Act, and section 336 of said title provides:

That every corporation, not exempt under section 304, shall make a return for the purposes of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places, in the same manner, and subject to the same conditions, as is provided in the case of returns and payment of income tax by corporations for the purposes of Title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

Section 1000, Title X, of the Revenue Act of 1918, imposes on corporations a special excise tax with respect to carrying on or doing business, and subdivision (d) of said section provides:

Section 257 shall apply to all returns filed with the Commissioner for purposes of the tax imposed by this section.

Pursuant to the authority contained in these provisions of law or under laws heretofore enacted in substitution or amendment thereof and not inconsistent herewith, the following rules and regulations are prescribed:

1. The proper officers of a State imposing an income tax are entitled as of right, upon the request of its governor, to have access to the income and profits tax returns of a corporation, association, joint-

stock company or insurance company, or to an abstract thereof showing its name and income. Proper officers, in this connection, are only those officers of the State who are charged with the enforcement of the State income tax law, and who are to use the information gained by the access only in connection with such information.

2. The request or application of the governor must be in writing signed by him under the seal of his State and must show:

(*a*) That the State imposes an income tax.

(*b*) The name and address of the corporation, association, joint-stock company, or insurance company making the returns to which access is desired.

(*c*) Why access is desired.

(*d*) The names and official positions of the officers designated to have the access.

(*e*) That such designated officers are charged with the enforcement of the State income tax law.

(*f*) That the information to be gained by the access is to be used only in connection with such enforcement.

3. The request or application of the governor may be addressed either to the Secretary of the Treasury or to the Commissioner of Internal Revenue, but should be transmitted to the Commissioner, who will set a convenient time for the access to the returns (or to an abstract thereof, as he may determine).

4. Access shall be given only in the office of the Commissioner of Internal Revenue in Washington.

5. The officers designated by the governor will not be permitted to name another person or persons to examine the returns (or abstracts) for them.

6. The officers designated will be given access only to the returns of those corporations, associations, joint-stock companies, or insurance companies organized or doing business in their State.

7. The officers designated may have access to lists furnished to supplement and become a part of the returns to which they are given access.

8. The proper officers, as defined in paragraph 1, may have access to the capital stock tax returns filed under the provisions of section 1000 of the Revenue Act of 1918 under the same conditions prescribed in the preceding paragraph for access to the income and profits tax returns of corporations, associations, joint-stock companies, and insurance companies. This right does not extend to the examination of capital stock tax returns filed pursuant to prior Acts of Congress.

9. All former regulations bearing on the subject herein covered are hereby superseded.

III. *Examination by a stockholder of the annual income returns of a corporation made pursuant to Titles II and III and section 1000, Title X of the Revenue Act of 1918.*

Title II of the Revenue Act of 1918 imposes an income tax on corporations and requires them to file income returns. Section 257 of said title provides among other things:

> 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. Any stockholder who, pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both.

Title III of the Revenue Act of 1918 imposes a war profits and excess profits tax on corporations, in addition to other taxes imposed by the Act, and section 336 of said title provides:

That every corporation, not exempt under section 304, shall make a return for the purposes of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places in the same manner, and subject to the same conditions, as is provided in the case of returns and payment of income tax by corporations for the purposes of Title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

Section 1000, Title X, of the Revenue Act of 1918 imposes on corporations a special excise tax with respect to carrying on or doing business, and subdivision (d) of said section provides:

Section 257 shall apply to all returns filed with the Commissioner for purposes of the tax imposed by this section.

Pursuant to these provisions of law and any other laws that may be hereafter enacted in substitution or amendment thereof and not inconsistent herewith, a bona fide stockholder of record owning 1 per centum or more of the outstanding stock of a corporation shall be entitled as of right, upon making request of the Commissioner of Internal Revenue, to examine the annual income returns of such corporation and of its subsidiaries made under Titles II and III of the Revenue Act of 1918, and all returns of corporations filed for purposes of tax imposed by section 1000, Title X, of said Act. His request for permission to examine such returns must be made in writing and must be in the form of an affidavit showing his address, the name of the corporation, the period of time covered by the return he desires to inspect, the amount of the corporation's outstanding capital stock, the number of shares owned by him, the date when he acquired them and whether he has the beneficial as well as the record title to such shares. It must also show that he has not acquired his shares for the purpose of the examination of the income returns of the corporation. If he has acquired them for this purpose he is not a bona fide stockholder within the meaning of the statute. The application must be supported by satisfactory evidence showing that the applicant is a bona fide stockholder of record of the required amount of stock of the corporation. The supporting evidence may be partly in the form of a certificate signed by the president or vice president of the corporation, and countersigned by the secretary under the corporate seal. Upon being satisfied from the evidence presented that the applicant has fully met these conditions the Commissioner will grant the permission to examine the returns and set a convenient time for the examination in the office of the Commissioner. This privilege is personal and will be granted only to the stockholder who can not delegate it to another.

All former regulations bearing on this subject are hereby superseded.

IV. Inspection of returns in all other cases is governed by Presidential order and regulations, to which reference is made.

SECTION 257, ARTICLE 1091: Inspection of returns. 6-20-734 S. 1301

Concerning the inspection by debtor corporation of ownership certificates:

Advice is requested whether a debtor corporation should be permitted to inspect ownership certificates filed through it by owners of its bonds or of bonds of its subsidiaries.

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: * * *.

The President, on January 7, 1920, issued such an order and approved regulations governing the inspection of income tax returns. They are embodied in Treasury Decision 2961.

In Law Opinion 879 (Cumulative Bulletin, December, 1919, page 262) it was 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. This opinion dealt with the *furnishing copies* of ownership certificates and not with inspection thereof. The reasoning on which the conclusion was reached that ownership certificates should be treated as income tax returns under the regulations governing the furnishing of copies of such tax returns is equally controlling in determining whether ownership certificates should be treated as income tax returns under the regulations governing their inspection.

The regulations embodied in Treasury Decision 2961 make no provision for inspection of income tax returns by persons through whom such returns may have been filed, or through whose hands they may have passed before they were finally lodged in the department. In consequence it is not permissible, under the regulations, for ownership certificates to be inspected by the debtor corporation simply because they were filed through such corporation. There appears no other reason why the debtor corporation should be permitted to inspect the ownership certificates.

Held, that the regulations do not permit a debtor corporation to inspect ownership certificates made by owners of its bonds or bonds of its subsidiaries simply because such ownership certificates passed through the hands of such debtor corporation and were finally filed in the department by it.

SECTION 257, ARTICLE 1091: Inspection of returns. 22-20-978 O. D. 531

In accordance with section 257 of the Revenue Act of 1918 lists containing the names and post-office addresses of individuals making income tax returns to collectors are posted for public inspection in

the public corridors of collectors' offices and post-offices. Persons will not be allowed to enter the workrooms of collectors' offices either outside or during office hours for the purpose of making copies of such lists.

SECTION 260.—CITIZENS OF UNITED STATES POSSESSIONS.

SECTION 260, ARTICLE 1121: Status of citizen of United States possession.

(See 23-20-987; sec. 217, art. 312(a).) Resident of Porto Rico employed aboard vessel plying between United States and Porto Rico.

SECTION 261.—PORTO RICO AND PHILIPPINE ISLANDS.

SECTION 261, ARTICLE 1133: Taxation of corporations between United States and Porto Rico and Philippine Islands. 1-20-663 O. 976

INCOME TAX: REVENUE ACT OF 1916, AS AMENDED BY REVENUE ACT OF 1917.

Foreign Corporation Transacting Business in United States and Porto Rico.

A foreign corporation transacting business and having an office in both continental United States and Porto Rico is not subject to income tax in continental United States upon income derived from Porto Rico.

The disposition of the claim of the M company, for the refund of x dollars, income tax for 1917, depends upon the question of whether a foreign company transacting business and having an office in continental United States and in Porto Rico is liable to tax in continental United States upon income derived from Porto Rico.

Sections 10(a), 15, and 25 of the Revenue Act of 1916, as amended by the Revenue Act of 1917, provide as follows:

SEC. 10(a). That there shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation, joint-stock company or association, or insurance company organized in the United States, no matter how created or organized, but not including partnerships, a tax of 2 per cent upon such income; and a like tax shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources within the United States by every corporation, joint-stock company or association, or insurance company, organized or existing under the laws of any foreign country. * * *

SEC. 15. That the word "State" or "United States" when used in this title shall be construed to include any Territory, the District of Columbia, Porto Rico, and the Philippine Islands, when such construction is necessary to carry out its provisions.

SEC. 28. That the provisions of this title shall extend to Porto Rico and the Philippine Islands: *Provided*, That the administration of the law and the collection of the taxes imposed in Porto Rico and the Philippine Islands shall be by the appropriate internal revenue officers of those governments, and all revenues collected in Porto Rico and the Philippine Islands thereunder shall accrue intact to the general governments thereof, respectively: * * *

Section 5 of Title I of the Revenue Act of 1917, provides:

> That the provisions of this title shall not extend to Porto Rico or the Philippine Islands, and the Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

In the instant case the claimant filed a return of income with the Collector of Internal Revenue at Y and included therein the total income from the continental United States and Porto Rico. The office of the company in Porto Rico made a return of its income to the Porto Rican authorities, including therein the total income received in Porto Rico. The United States office of the company now claims that the income of the company received through its Porto Rican office should not have been included in the return made to the collector at Y.

The income tax imposed by the Revenue Act of 1916 extends to Porto Rico, but section 23 provides that the collection of the taxes imposed in Porto Rico shall be by the appropriate Internal Revenue officers of Porto Rico, and that all revenues collected in the Island shall accrue intact to the general government thereof. A domestic corporation is required to make a return of income received in the preceding calendar year *from all sources* to the collector of the district in which its principal office is located. If such a corporation receives income from sources in Porto Rico, it must include in its return the income received from Porto Rican sources even though Porto Rico assesses income tax upon such income (Law Opinion 732). A foreign corporation transacting business in the United States and having a principal office in the United States is required to make a return of income *from all sources within the United States* to the collector of Internal Revenue in which its principal office in the United States is located. Section 15 of the Act provides that the term "United States" shall include Porto Rico *when such construction is necessary to carry out its provisions.* It might, therefore, be plausibly argued that a corporation of the character of the claimant should include in its return of income to the collector in Y, the income received through its Porto Rican office. This would be upon the assumption that the term "United States" as used in section 10(a) of the Act includes Porto Rico, and that the corporation is obligated to include in such return its income received from all sources within continental United States and Porto Rico. No opinion is expressed as to the view which should be taken if the company has no office in Porto Rico and pays no tax to Porto Rico. Where, however, the corporation has an office in Porto Rico and pays a tax to the Porto Rican authorities upon income received in Porto Rico, it would seem proper to hold that the term "United States" as used in section 10(a) should not include Porto Rico. This Government should not take the position that it was the intention of Congress to impose a double tax upon any corporation in respect to income received from Porto Rican sources, nor should it take the position that the Porto Rican Government is not entitled to tax income received through a Porto Rican branch of a foreign corporation. This view is supported by the fact that section 5 of Title I of the Revenue Act of 1917 specifically provides that the additional 4% tax imposed by that Act shall not extend to Porto Rico.

Although the fact is not entirely clear as to whether the branch of the claimant in Porto Rico transacts business direct with the home office or only with the Y office, it is considered that this question is immaterial. Even though the Porto Rican branch is a branch of the Y office, it is nevertheless held that the Y branch is not required to include in its tax return the income received through its Porto Rican branch. The claim should, therefore, be allowed and not rejected.

In conclusion, it is held that a foreign corporation transacting business and having an office in both continental United States and Porto Rico is not subject to income tax in continental United States upon income derived from Porto Rico.

Title III—WAR PROFITS AND EXCESS PROFITS TAX.

PART II—IMPOSITION OF TAX.

SECTION 301.—IMPOSITION OF TAX.

SECTION 301, ARTICLE 711: Imposition of tax. 12-20-794
(Also Section 218, Article 321.) A. R. R. 43

RULING UNDER REVENUE ACT OF 1917.

A partnership which was dissolved in July, 1917, appealed from the action of the Unit in taxing it under the Revenue Act of 1917, on the ground that the dissolution antedated the passage of the Act.

This position is untenable in view of the decision of the United States Supreme Court in *Brady* v. *Anderson*. The fact that the partnership was dissolved in July, 1917, did not absolve it from excess profits tax on profits made during the calendar year 1917 prior to its dissolution.

SECTION 301, ARTICLE 711: Imposition of tax. 16-20-870
A. R. R. 65

REVENUE ACT OF 1917.

The Committee has had under consideration the appeal of A against a proposed excess profits tax for 1917, based upon profits made through the sale of fractional interests owned by him in various American vessels.

The practice which has grown up relative to the ownership, management, and operation of American vessels, especially with relation to sailing vessels in the coastwise trade, is well recognized. Fractional undivided interests, usually of one thirty-second or sixty-fourth, are commonly sold to investors in this class of property.

In Law Opinions 389 and 442 the Solicitor held that the operation of a vessel, fractional shares in which were owned by different parties, by a managing owner or agent for the account of all, does not constitute either a joint-stock association or a partnership, and that no tax is payable by the management of the vessel as such or by the owners as a group. The question then arises as to whether or not the individual owners of fractional shares are separately taxable for excess profits tax upon their returns from such business.

In a brief filed in this case the following statements are made, which the Committee believes are true and are characteristic of the methods pursued.

The method by which the above-described property comes into existence is commonly as follows: A shipbuilder who both builds and manages vessels, or a shipowner who has the control of vessels and manages them, builds, or secures the building of, a vessel for some captain who wants a ship. Generally the builder and the operator assume the greater part of the burden of construction,

but they are constantly endeavoring to sell pieces of the craft to people they know or to people of whom they may learn through finding their names in the various custom houses where their names appear as owners of interests in other vessels. In this way interests in vessels are scattered about until the average schooner of to-day will show a list of more than 50 owners. The owners are, as a rule, unknown to each other; they hold no meetings to discuss plans for the ship; they, in fact, have practically nothing to say as to who shall manage the vessel—the builder or the capitalist who caused the vessel to be built retains the management in himself; and, as a rule, all the individual owner knows regarding the vessel and what it is doing, is learned from the "statement" which is sent out at the conclusion of each voyage, which statement sets forth the fact that this vessel has completed a voyage; that she was paid a certain sum of money for carrying the cargo on that voyage; that the expenses of the voyage—wages, towages, supplies, port charges, etc., amounted to a certain sum; that the net amount of money in the manager's hands after paying all bills is a certain sum of which the proportionate part belonging to owner addressed is so much—a check for the same being inclosed. * * *

The individual owner of a vessel gives no time or attention to the management of the vessel, has nothing to say regarding the business she shall do and, in fact, knows as little of her doings in advance as does a stranger. Each owner of an interest is independent of every other owner—some insure, some do not. Each buys into, or sells out of, the vessel without consulting any other owner or the "agent," and often the first knowledge the "agent" has that there is a new owner in the vessel is when the purchaser notifies him that the earnings which heretofore were sent to the seller must now come to him.

It appears clear that A could have given no personal attention to the management of any of the vessels in which he owned fractional shares, and the only foundation for assessing him a tax is on the assumption that he either made a business of buying and selling such shares, or that the manager of the vessel was in fact his agent for such management. Neither of these grounds appears to be tenable. A's interests appear to have been that of an investor in property of this description and he certainly was no more engaged in the business of operating vessels through an agent than is an investor in real estate whose rental operations are conducted by an agent engaged in the real estate business.

The Committee is therefore of the opinion that A is not liable for excess profits tax on the profits made through the sale of his interests in various vessels unless it can be shown that he gave enough time and attention to the buying and selling of such interests to constitute a business. It is understood that income tax was duly paid upon all the profits and receipts from property of this character.

SECTION 301, ARTICLE 711: Imposition of tax. 16–20–871
A. R. M. 41

REVENUE ACT OF 1917.

Held, that the profit from the sale of stock of the M and N Companies in 1917 by A constitutes income from business or trade and as such is subject to excess profits tax. The sale of rights acquired through the ownership of stock in any oil-producing corporation in which the owner is not a managing executive officer or employee is considered an isolated transaction and not subject to excess profits tax.

Opinion is requested as to whether A is subject to excess profits tax on profits derived from the sale of stock in the M and N companies during the year 1917.

It appears that A is an expert oil man and devotes his time, energy, and money to the purchase and sale of oil and gas leases and to the development of same. It appears that A for the years prior to 1917 had been regularly engaged in promoting oil corporations and dealing in oil and gas leases. In 1917 he disposed of his entire holdings of the capital stock of the M company and of the N company. In these companies he held all the stock except the necessary qualifying shares. By way of explanation and leading up to the acquisition of the stock in the companies mentioned above, it appears that A would secure certain leases on oil and gas properties and then turn same over to the corporation, issuing to himself the entire capital stock. He was an active officer of the companies prior to the date of sale of his stock, and after such stock had been sold he devoted his time and attention to the mining business.

The question here presented for decision is whether A was engaged in business or trade in the year 1917 for the purpose of determining his liability for excess profits tax on the gains through the sale of the stocks of the two oil companies of which he was sole owner and the active managing director.

Section 201 of Title II of the war excess profits tax law for 1917 provides that this title shall apply to all trades or businesses of whatever description whether continuously carried on or not. The terms "trade" and "business" as used in the Revenue Act of 1917 include occupations and professions.

Article 8, Regulations 41, provides that:

> In the case of an individual, the terms "trade," "business," and "trade or business" comprehend all his activities for gain, profit, or livelihood, entered into with sufficient frequency, or occupying such portion of his time or attention as to constitute a vocation, including occupations and professions. When such activities constitute a vocation they shall be construed to be a trade or business whether continuously carried on during the taxable year or not, and all the income arising therefrom shall be included in his return for excess profits tax.
>
> In the following cases the gain or income is not subject to excess profits tax, and the capital from which such gain or income is derived shall not be included in "invested capital"; (a) gains or profits from transactions entered into for profit, but which are isolated, incidental, or so infrequent as not to constitute an occupation, and (b) the income from property arising merely from its ownership, including interest, rent, and similar income from investments, except in those cases in which the management of such investments really constitutes a trade or business.

"Business" has been defined as that which occupies and engages the time, attention, and labor of any one for the purpose of livelihood, profits, or improvement—that which is his personal concern or interest, employment, regular occupation, but it is not necessary that it should be his sole occupation or employment. Regular service connected with ownership, as in this case, constitutes an occupation or business.

The head of the Income Tax Unit in transmitting this case on appeal urges strongly that the profits from the sale of stock in these companies constitute profits derived in a trade or business and, therefore, subject to excess profits tax irrespective of that provision of Treasury Decision 2135, which provides:

> Neither the investment by an individual of money in the stock of a company nor the employment by the company of his services in any official capacity can serve to make the business in which the company was engaged a matter of his individual trade.

In the consideration of this case it appears that A devoted in 1917 all of his time to the corporation in which he was the sole stockholder. The time devoted to the acquisition of this stock when considered with the time devoted to the acquisition of certain leases and A's regular employment for the years prior to 1917, warrants but one conclusion, and that is that A is engaged in the business of dealing directly or indirectly in the purchase and sale of oil, gas, and mining leases. The ownership of this stock was incidental to his business and along the line of his general activity.

It appears to the Committee that this case is analogous to that of a farmer who sells his farm or a certain portion of his farm at a profit, and the ruling has been consistent that such sale of assets used in business constitutes income from a business and, therefore, subject to excess profits tax. In the instant case A did not sell the assets of the corporation, but sold the evidence of ownership of such assets by selling the shares of stock in the corporation of which he was the sole owner.

It can not be said that the time devoted to the acquisition of stock or investment of money in the O company required sufficient time and attention or was entered into with sufficient frequency to constitute an occupation or business. The acquisition of rights through the ownership of stock in this company and the sale of such rights can not properly be considered as income from a business or trade.

After considering all the facts in this case the Committee is of the opinion that the profit from the sale of the capital stock of the M Company and the N Company by A in 1917 is properly to be classed as profit derived from a trade or business and, therefore, subject to excess profits tax for the year 1917.

The Committee is also of the opinion that the amount received from the sale of rights in 1917 is not income from a trade or business, but should be considered as profit from an isolated transaction and as such not subject to the excess profits tax.

SECTION 301, ARTICLE 711: Imposition of tax. 17–20–879
A. R. M. 40

REVENUE ACT OF 1917.

A physician owned a farm and a part interest in certain oil leases. He spent practically his entire time in 1917 in practicing his profession. The farm was rented out on a cash rental basis; and the management of the interest in the oil leases was in the hands of another individual, the physician merely receiving his share of the net proceeds. Both the farm and the interest in the oil leases were sold at a profit in 1917. Held, that the physician was not engaged in the business of farming in 1917, neither did he devote sufficient time and attention to the purchase, promotion, or sale of oil properties during 1917 to constitute a trade or business within the meaning of the Revenue Act of 1917. The profits derived from the sale of the farm and the interest in the oil leases were therefore not subject to excess profits tax.

The terms "trade" and "business" as used in the Revenue Act of 1917 include professions and occupations. The term "business" has

been defined as that which occupies and engages the time, attention, and labor of any one for the purpose of livelihood, profit, or improvement; that which is his personal concern or interest; employment; regular occupation; but it is not necessary that it should be his sole occupation. Under this definition of business it appears that regular service performed constitutes an occupation or business. Whether or not the income from this service is subject to excess profits tax is dependent upon the time and attention devoted to the occupation or business.

SECTION 301, ARTICLE 714: Computation of tax on income from Government contracts. 3–20–695 O. D. 378

The excess profits credit and the war profits credit, as provided in section 301(c) 1, Revenue Act of 1918, and article 714 of Regulations 45, are computed on the basis of the invested capital for the taxable year, not on the invested capital for 1918.

SECTION 301, ARTICLE 714: Computation of tax on income from Government contracts.

(See 12–20–791; sec. 1, art. 1510.) Contract entered into prior to April 6, 1917, and provisions of section 3744, Revised Statutes, complied with subsequent to that date.

SECTION 301, ARTICLE 714: Computation of tax on income from Government contracts.

(See 12–20–799; sec. 240, art. 637.) Taxability of income derived from Government contracts by affiliated corporations.

SECTION 301, ARTICLE 714: Computation of tax on income from Government contracts. 22–20–979 O. D. 532

In 1919 a corporation derived a profit in excess of $10,000 from Government contracts, but sustained a net loss on other operations. Held, that it may deduct the amount of such loss in ascertaining its net income subject to tax. If the amount of the excess profits credit exceeds the company's total net income from all sources for 1919 no tax will be imposed upon the portion of its net income for that year which was derived from Government contracts.

Since the company's net income included an item of net profit from Government contracts in excess of $10,000, it will be required to supply fully all of the data called for by the supporting schedules of Form 1120–S.

SECTION 301, ARTICLE 715: Allocation of net income to particular source.

(See 5–20–721; sec. 1, art. 1510.) Allocation of expenditures and of goods on hand at close of year in connection with Government contracts.

SECTION 303.—TAX WHEN PARTLY PERSONAL SERVICE BUSINESS.

SECTION 303, ARTICLE 742: Computation of tax upon net income. 8-20-759 S. 1317

INCOME AND EXCESS-PROFITS TAXES—REVENUE ACT OF 1917.

Dealer selling coal at wholesale on commission and operating retail yard.

A merchant who sells coal at wholesale on a commission basis and also sells coal at retail from his own yard is engaged in only one business for the purpose of computing the excess profits tax.

The claim of A, for the refund of a portion of his individual income and excess profits taxes assessed for the year 1917, raises the question whether a merchant selling coal at wholesale on a commission basis and also selling coal at retail from his own yard is entitled to divide his income from the business and pay the excess profits tax at the rate of 8 per cent upon the net income derived from the commission business, and at the graduated rates of tax upon income derived from the sale of coal at retail.

Section 201 of the Revenue Act of 1917, imposes an excess profits tax upon the income of individuals derived from a business or trade. Section 204 of the Act provides in part:

A trade or business carried on by a corporation, partnership, or individual, * * * shall, for the purposes of this title, be deemed to have been in existence, etc.

In the instant case the claimant is a dealer in coal and coke. He operates a coal yard and in connection with that business sells coal in carload lots on a commission basis. He assumes responsibility for the collection of the sale price upon coal sold in carload lots after the cars have left the mine. The overhead expense connected with the commission business can not readily be segregated from the overhead expense connected with the operation of the coal yard. The evidence goes to show that the claimant has only a single business which is that of a coal merchant. If a person wishes to buy a small amount of coal, it is sold at retail from his yard; if the person buys a carload lot, it is ordered shipped direct to him from the mine and the coal merchant receives a commission upon the sale. There is nothing to indicate that the claimant keeps separate books of account relative to his commission business and his retail business, nor is it believed that if he should keep such books of account that he would be entitled to claim that a part of his income from the coal business was derived from a business having no invested capital and a part from a business having an invested capital.

It is true that in the case of a person carrying on entirely unrelated businesses, one of which requires invested capital and one of which does not, the regulations permit him to separate the income from those businesses. Thus, in the answer to the tenth question contained in the excess profits tax primer, it is held that a doctor who also manages and directs a small factory which he owns will be subject to a tax of 8 per cent upon the fees received from his medical practice and to a graduated tax on the income from the factory. It is held, however, in the answer to question seven of the

primer, that a person who owns and operates a dry-goods store and also owns and operates a shoe store may not separate the businesses for the purpose of computing the tax, and in the ninth question it is held that a contractor and dealer in real estate who also lists property owned by others and does business as a real-estate agent or broker has only one business. It is stated "these activities are so interrelated as to constitute one business." See also Income Tax Ruling 33, which is referred to in Solicitor's Memorandum 929.

It does not clearly appear that the taxpayer is entitled to any relief. If he is, apparently it should be granted under section 210.

PART III.—CREDITS.

SECTION 311.—WAR PROFITS CREDIT.

SECTION 311, ARTICLE 783: War profits credit where no prewar period. (Also Section 327, Article 901.) 10-20-783 A. R. R. 36

Held, that the median as determined under the provisions of paragraph (c) (2) of section 311 of the Revenue Act of 1918 is final and shall be used in computing the war profits credit of the M Company. Relief can not be granted under section 328 of the Act merely for the reason that the application of the median does not give the relief to which taxpayers think they are entitled.

The M Company claims that inequity and hardship are imposed upon it through the application of the "median" in determining its war profits credit under the Revenue Act of 1918 and requests the Commissioner to determine its tax liability under the provisions of section 328 for the reason that the median as determined allows the taxpayer a war profits credit of slightly in excess of 10 per cent.

It is contended that this percentage is not a representative percentage earned by corporations in the same general class of business during the prewar period. The taxpayer has made an independent investigation and apparently has taken into consideration only a few concerns similarly situated and claims that these concerns earned over 20 per cent during the prewar period. The Bureau has computed the median by using the returns of all corporations in same general class of business as that conducted by the M Company.

On account of this discrepancy the Commissioner is urged to ascertain and assess the tax in this case as provided in section 328 of the statute.

Section 311 (c) of the Revenue Act of 1918 provides in part:

If the corporation was not in existence during the whole of at least one calendar year during the prewar period, then, except as provided in subdivision (d), the war profits credit shall be the sum of: (1) A specific exemption of $3,000; and (2) an amount equal to the same percentage of the invested capital of the taxpayer for the taxable year as the average percentage of net income to invested capital for the prewar period, of corporations engaged in a trade or business of the same general class as that conducted by the taxpayer; but such amount shall in no case be less than 10 per centum of the invested capital of the taxpayer for the taxable year. Such average percentage shall be determined by the Commissioner on the basis of data contained in returns made under Title II of the Revenue Act of 1917, and the average known as the median shall be used.

Article 783 of Regulations 45 interpreting the above-quoted provision of law provides in part as follows:

> If a corporation has no prewar period, then the war profits credit consists of the sum of the specific exemption of $3,000 and an amount equal to the same percentage of the invested capital for the taxable year as the average percentage of net income to invested capital for the prewar period of corporations engaged in a trade or business of the same general class as that conducted by the taxpayer, but not less than 10 per cent of its invested capital for the taxable year. The war profits credit shall be computed in the first instance on the basis of 10 per cent of the invested capital, and when the average percentage of corporations engaged in the same general class of trade or business has been determined the amount of the tax will if necessary be recomputed.

Section 327 of the Revenue Act of 1918 provides that in certain cases the tax shall be determined as provided in section 328. In the instant case it can not be said that the Commissioner is unable to determine the invested capital, that the taxpayer is a foreign corporation, that a mixed aggregate of tangibles and intangibles has been paid in for stock, etc., nor that the tax if determined without the benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work an exceptional hardship evidenced by a gross disproportion between the tax computed without the benefit of section 327 and the tax computed by reference to representative corporations as provided in section 328.

Section 327 does not apply to any case in which the tax is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital.

After analyzing the situation presented in the instant case the Committee is of the opinion and recommends (1) that the median established as provided by law and published by the Bureau be considered final and that the taxpayer is not entitled to consideration under the provisions of section 328 of the statute; (2) that there is no warrant in law or the regulations which authorizes the Commissioner to allow a larger percentage in this class of cases than that established by the median for the purposes of computing the war profits credit; and (3) that the instant case does not fall within any class of cases enumerated in section 327, therefore, relief can not be granted under section 328.

PART V.—INVESTED CAPITAL.

SECTION 325.—TERMS RELATING TO INVESTED CAPITAL.

SECTION 325, ARTICLE 812: Borrowed capital: securities. 21-20-962 A. R. R. 116

REVENUE ACT OF 1917.

> Held in the matter of the appeal of the O Company (Inc.), that the debenture bonds in the amount of $10x$ dollars can not be included in the computation of its invested capital.

The Committee on Appeals and Review has had under consideration the appeal of the O Company from a decision of the Income Tax Unit eliminating an item of $10x$ dollars from the invested capital of this corporation.

It appears that prior to 1911 the business was conducted as a copartnership. The copartnership transferred its assets to the O Company and received in payment therefor debenture bonds in the amount of $10x$ dollars, payable in 30 years, bearing interest at the rate of 6 per cent per annum. The copartnership also received other good and valuable consideration in the form of common stock in the amount of $20x$ dollars, which was issued against good will, trade-marks, etc. The debenture bonds issued in payment for the assets of the copartnership were delivered to the partners pro rata. The common stock issued was distributed to the partners in the same ratio as the bonds. The debenture bonds were issued in payment for the tangible assets of the copartnership, which were worth approximately $11x$ dollars, as set forth in a schedule attached to the brief of the corporation, and the common stock was issued in payment for good will, trade-marks, etc.

The revenue agent, under date of August 21, 1919, submitted a report in which he recommended that additional taxes be assessed against the O Company for the years 1916 and 1917.

It was contended that since the resolution of acceptance of the terms of the sale by the O Company distinctly sets forth that the bonds should be "subject to all rights of creditors of said corporation now existing and at all times existing during the term of said bonds," such bonds are in fact no more than 6 per cent preferred stock and that the property for which the debenture bonds were issued was already invested in the business and fully paid for and, therefore, the situation was not one where the corporation borrowed money against the issuance of debenture bonds and subsequently purchased goods or developed its business.

It may be conceded that the provision of the offer of sale of the partnership property and the resolution of acceptance thereof, which provided that the bonds should be "subject to all rights of creditors of said corporation now existing and at all times existing during the terms of said bonds," was fully operative (because it constituted one of the conditions on which they were issued) as between the original bondholders having actual notice and knowledge thereof, and who it appears have always retained ownership thereof, thus eliminating from consideration the situation resulting if the bonds had been held by innocent third parties. The facts therefore appear in their most favorable aspects to the taxpayers. The attorneys submitted further to substantiate the contention that these bonds were nothing more than preferred stock, that the debentures were in 1918 turned in by the owners of the O Company and preferred stock was issued in lieu thereof to the respective owners of the bonds. This, it is urged, shows that the owners of these bonds recognized that they were subordinate both as to payment of principal and interest to the rights of the general creditors of the corporation.

Where a corporation purchased certain assets, paying therefor by creating a bonded debt drawing 6 per cent interest per annum, which, though a subordinate lien to claims of general creditors of the corporation, was nevertheless superior to the rights of stockholders of the corporation, so that on a dissolution such bonds would be first paid before the stockholders could be admitted to share in the assets of the corporation, the bonds represent borrowed money and not

invested capital within the meaning of section 207, Revenue Act of 1917.

Article 44(b) of Regulations 41 provides that—

> The term "money or other property borrowed" as used in section 207 and these regulations includes not only cash or other borrowed property which can be identified as such, but current liabilities and temporary indebtedness of all kinds, and any permanent indebtedness upon which the taxpayer is entitled to an interest deduction in computing net income. A corporation which under the income tax law is allowed to deduct only a part of the entire interest paid upon its indebtedness, may include in its invested capital such a proportion of its permanent indebtedness as the amount of interest upon such indebtedness which the corporation is not allowed to deduct is of the total amount of interest paid upon such indebtedness during the taxable year.

Section 325(a) of the Revenue Act of 1918 provides that as used in this title:

> The term "borrowed capital" means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise.

Article 812 of Regulations 45 provides that—

> Any interest in a corporation represented by bonds, debentures, or other securities, by whatever name called, including so-called preferred stock, if with respect to the payment of either interest or principal it ranks with or prior to the interest of the general creditors, is borrowed capital and can not be included in computing invested capital. Any such preferred stock may, however, be so included if it is deferred with respect to the payment of both interest and principal to the interest of the general creditors.

In general, it might be said that it is always a question of fact whether a given amount paid or left in the business of a corporation constitutes borrowed capital or paid-in surplus. The general principle is that if interest is paid, or is to be paid, on any such amount, or if the stockholders' or officers' right to repayment of any such amount ranks with or before that of the general creditors, the amount so left with the corporation must be treated as borrowed capital.

In the instant case, the bonds were issued in payment for property, interest has been regularly paid each year and has been deducted by the corporation in computing its net income for each year up to and including 1916, but no interest deduction on account of this indebtedness was claimed for 1917, even though the corporation actually paid 6 per cent on the outstanding debenture bonds.

The Committee is of the opinion that the O Company is not entitled to include in the computation of its invested capital the item of debenture bonds on which interest was paid but not deducted in the computation of the invested capital for 1917. The corporation will, however, be entitled to a deduction in computing its net income of the interest so paid on these bonds within the statutory limitation with respect to the payment of interest for the year 1917.

The intent of the parties in this case was truly reflected in the form in which they organized their corporate business. They chose to organize and carry it on by creating a corporate debt to be repaid at a future date, plus a fixed rate of interest evidenced by the debenture bonds secured by a lien on corporate assets, subordinate to claims of its general creditors. Bondholders have different rights or interests in corporate business and assets than would preferred stockholders. True, preferred stock might have been issued in lieu thereof, but the parties elected otherwise, and they are bound by their

act so long as the bonds in question are outstanding. The subordination of the lien of the bonds to claims of general creditors is not enough to render the bonds the equivalent of preferred stock. Nor is the mere fact that possibly in an effort to characterize the bonds as the equivalent of preferred stock the corporation did not deduct interest thereon in filing its return for 1917 sufficient to change or fix their status.

A memorandum supplementing the original brief has been filed in which the attorneys refer to and quote from certain court decisions to the effect that, as between the corporation and the original purchasers, the bonds were subordinate both as to the payment of principal and interest to the rights of the general creditors. The bonds in question are an obligation of the corporation to pay and in the judgment of the Committee should be classed as "borrowed capital."

The Committee therefore recommends that the decision of the Income Tax Unit disallowing the item of $10x$ dollars from the invested capital of the O Company be sustained and that the case be otherwise closed in accordance with this recommendation.

SECTION 325, ARTICLE 813: Borrowed capital; amounts left in business. 18-20-904 A. R. R. 78
(Also Section 200, Article 1524.)

REVENUE ACT OF 1917.

The copartnership of A and B has appealed from the decision of the Income Tax Unit holding that its tax liability for 1917 should be determined under the provisions of section 210 of the Revenue Act of 1917 and denying classification under the provisions of section 209 of the statute.

It is urged strongly that this copartnership is entitled to classification under the provisions of section 209 for the reason that the capital used in the business is nominal when compared with the gross volume of business, of which about 45 per cent was from sales on which the partnership received commissions and the balance was from sales in which the partnership was unquestionably trading as a principal; also that if under the regulations this copartnership could not be given a classification under the provisions of section 209, it should at least be entitled to a constructed capital under the provisions of section 210, greatly in excess of the invested capital as constructed by the Unit which it is claimed is not representative of the invested capital of concerns in a similar or like trade or business. It is claimed further than x dollars used by the partnership during the greater part of 1917 and shown on the balance sheet as a liability to B, one of the partners, was invested capital within the meaning of section 207 of the statute and of regulations issued thereunder, for the reason that any amount which had been used by a partnership during the year, even though such amount had been borrowed individually by one of the partners and was subject to withdrawal by the partner at any time, should during the period of its use be treated as invested capital. The partner in such case would be individually

liable for the payment of such money and as to the partnership no preferred liability to pay exists.

It appears also that the copartnership used considerable borrowed capital in the operation of its business for the year 1917 and that the item of x dollars was an amount which had been left in the business or advanced by one of the partners without requiring the partnership to give its notes for the repayment of same, and also without requiring the partnership to pay interest on such amount.

Section 207 of the Revenue Act of 1917 provides, among other things, that as used in this title the term "Invested capital" means:

* * * In the case of a corporation or partnership: (1) Actual cash paid in, (2) 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 first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid-in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year: * * *.

Article 53 of Regulations 41 provides that:

In computing invested capital, every corporation or partnership paying taxes at the graduated rates prescribed in section 201 (see art. 16), shall add together its paid-in capital and its paid-in or earned surplus and undivided profits (under whatever name the same may be called) as shown by its books at the beginning of the taxable year. The total thus obtained shall be adjusted for any asset or item which it covers that is not carried on the books at the valuation prescribed by law or by these regulations. When necessary, adjustment (addition or subtraction) shall be made in respect of the following: * * *

Whether a given amount paid into or left in the business of a partnership constitutes borrowed capital or paid-in surplus is largely a question of fact. Indebtedness to the partners actually canceled and left in the business would ordinarily constitute paid-in surplus. The general principle is that if interest is paid, or is to be paid on any such amount, or if the partners' or shareholders' right to repayment of such amount ranks with or before that of general creditors, the amount so left in the partnership should be considered borrowed capital and be so treated in computing invested capital. In the instant case, however, no notes were given to B, one of the partners, and no interest was paid by the partnership. Any amount of money, therefore, that is borrowed by one partner and contributed to the partnership, even though such partner may have a right to withdraw such amount at his discretion, and especially where the partnership does not pay interest on such amount and has not given its note for the repayment of such amount, the money so paid in would not rank prior to or with that of the general creditors and in the judgment of the Committee it should be included in the computation of invested capital.

The Committee is of the opinion that the framers of the law contemplated that contributions of any amount from joint partners to the partnership would form part of the aggregate capital of the partnership and would not fall within the category "money or other property borrowed." A distinction should, however, be made where the partnership having bills of lading in its name, takes such bills of lading to banks with a note attached, and borrows money which the

partnership is primarily liable to pay and the partners are secondarily liable to pay in the event of failure of the partnership. This, in the judgment of the Committee, would constitute borrowed capital used in the business of a partnership.

All the facts presented have been carefully considered and the Committee is of the opinion that the item of x dollars which admittedly belongs to B, one of the partners, and which could be withdrawn at his discretion, should be used in computing the invested capital of this copartnership; that the Unit was in error in the determination of the tax under the provisions of section 210 of the statute and was correct in denying classification and determination of tax liability under the provisions of section 209 of the statute, and that the tax liability of this partnership for 1917 should be determined under the provisions of sections 201 and 207 of the statute.

SECTION 325, ARTICLE 813: Borrowed capital; amounts left in business. 18-20-905 A. R. M. 44

REVENUE ACT OF 1917.

Advice has been requested as to whether an amount paid into a corporation ratably by its stockholders under corporate resolution authorizing and making the assessment can be properly treated as invested capital of the corporation, even though its books indicate and show that the amount so paid in has been treated as a loan; that interest has been regularly paid to the contributing stockholders and that the corporation has regularly deducted the interest so paid in making its returns up to 1917.

A revenue agent submitted a report of his examination of the tax liability of this company and recommends the elimination of the amount so paid in from its invested capital for the reason that such amount has been treated on the books of the company as borrowed capital and further, for the reason that it has regularly each year in computing its net income deducted interest on this amount at the rate of 5 per cent per annum. No capital stock was issued for this amount of money paid in and no notes were given by the corporation acknowledging its indebtedness to the stockholders for this amount.

The amount paid in in accordance with the corporate resolutions was entered on the books of the company as a capital reserve fund and in 1917 it was carried as "Advances by stockholders."

The company urges strongly that this amount is not borrowed money. It is urged by the taxpayer that it makes little difference whether or not interest was paid on this amount and it submits that the payment of the interest is not determinative of the question involved. The payment or nonpayment of interest, it is contended, does not change the character of this capital and whether such capital is borrowed money or paid in surplus must be determined by the facts and by the intentions of the parties. This can best be determined from the books and records of the company. The taxpayer submits that its records clearly show that the amount was paid in as assessments in pursuance of corporate resolutions duly passed by the board

of directors and that the amount so paid in was set up on the books as "Reserve capital." The company further urges that inasmuch as no notes or other evidences of indebtedness were issued for this money, there was no obligation to repay same to the contributors other than that attaching with respect to the original capital.

Section 207 of the Revenue Act of 1917 provides 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, nor money or other property borrowed.

Article 44 of Regulations 41 provides, in part, as follows:

> The term "money or other property borrowed" as used in section 207 of these regulations includes not only cash or other borrowed property which can be identified as such, but current liabilities and temporary indebtedness of all kinds, and any permanent indebtedness upon which the taxpayer is entitled to an interest deduction in computing net income. A corporation, which under the income tax law is allowed to deduct only a part of the entire interest paid upon its indebtedness, may include in its invested capital such a proportion of its permanent indebtedness as the amount of interest upon such indebtedness which the corporation is not allowed to deduct is of the total amount of interest paid upon such indebtedness during the taxable year.

The Committee has considered all the facts presented in this case and has reached the conclusion that the money paid into the company under corporate resolution for which no notes were given nor even authorized does not fall within the provisions of article 812, Regulations 45. It is not thought that any court of equity or law would permit the repayment of this money ratably to the stockholders and interest thereon before the general creditors had been satisfied. If this assumption be correct, then assessments paid in would be subordinated to the rights of the general creditors as to the payment of both the principal and interest thereon.

Therefore, after careful consideration of the brief submitted by the company, and the recommendations of the revenue agent in this case, it is the opinion of the Committee that in determining the invested capital of this corporation the minute books of the corporation showing the resolutions making the assessment against the stockholders, reflect more clearly the true nature of the transaction than do mere bookkeeping entries concerning the same transaction made at a later date by a subordinate officer of the corporation. Although the sums paid to the stockholders as a return on their capital on account of these assessments were noted on the books of the corporation as interest, the facts indicate that such payments were more in the nature of dividends. The books of the corporation treat the amounts paid by assessment as an obligation of the corporation. This is true, but so also are amounts paid in for capital stock carried as liabilities of a corporation. The resolutions authorizing the assessments do not provide that interest shall be paid to the stockholders, no notes or other evidence of indebtedness are given by the corporation, and the stockholders are not preferred over general creditors as to the amounts paid in assessments.

Held, that the corporation may include in its invested capital for 1917 the amount assessed against its stockholders and paid in by them.

SECTION 325, ARTICLE 813: Borrowed capital: amounts left in business. 21-20-963 A. R. R. 102

REVENUE ACT OF 1917.

Held in the appeal of the M Company that the amount of 36x dollars standing upon the books of the company to the individual credits of three stockholders, at the beginning of business July 1, 1916, is not invested capital within the meaning of the Revenue Act of 1917.

The M Company is a corporation, all of the stock of which was owned by three stockholders, A, B, and C. During the lifetime of these stockholders no distribution of profits was made and the earnings were allowed to accumulate from year to year.

At the death of A, in 1907, the board of directors passed a resolution ordering the reserve fund to be prorated and credited to the deposit accounts of the three principal stockholders.

In accordance with this resolution the accumulated profits were divided and placed to the credit of these various accounts. None of these profits was withdrawn; the business proceeded as before and the profits were allowed again to accumulate until 1909, when B died, and the same procedure was taken as in 1907; although it does not appear in the record that there was formal action on the part of the directors, nor is the rate of the division nor the total amount divided, shown.

From the inception of the business until the present day no dividend has been declared nor have any of the profits been withdrawn from the business or segregated from the surplus of the company except as hereinbefore stated; but against the accounts credited as above, comparatively small charges have been made from time to time to cover living expenses of two of these stockholders. It is contended and sworn to that substantially all of the profits thus credited to these three stockholders have been, by verbal agreement, left in the corporation funds for the conduct of its business and that on the amounts so credited no interest has ever been paid by the corporation nor have notes been issued therefor, for the reason that they never have been considered as obligations of the corporation; but, on the contrary, as funds left in the business to be used as capital; and deponents further declare that the banks and other large creditors of the corporation were, and are, cognizant of this verbal agreement, and by reason of it extend credit to the corporation on these funds considered as capital.

In support of this sworn statement there were submitted two identical affidavits of the presidents of two banks, to the effect that the amounts carried on the books to the credit of the stockholders were considered by their respective banks as capital left in the business of the corporation by those parties under a verbal agreement, and that on the strength of this agreement and the indorsement or guaranty given to these banks by the individuals named, credit was extended by these banks to the corporation; these credits amounting to 12x dollars and 25x dollars, respectively.

On this statement of facts, which is not contested by the Income Tax Unit, the taxpayer appeals to this Committee to have these credits to these individual stockholders, which on July 1, 1916,

amounted to 36x dollars considered as invested capital of the corporation; the Unit having denied such consideration.

Section 207 of the Revenue Act of 1917 provides that—

* * * As used in this title "invested capital" does not include * * * money or other property borrowed, and means, subject to the above limitations: (*a*) In the case of a corporation or partnership: (1) Actual cash paid in, * * * and (3) paid in or earned surplus and undivided profits used or employed in the business, * * *.

In the consideration of this case no question of good faith or of fact is involved. There is no doubt that these amounts have been left in the business in accordance with the verbal understanding above referred to, to be used as capital, or that they have been so used as necessary contributions to the working capital of the business, which has expanded so rapidly that their withdrawal would at all times have rendered necessary some provision for the financing of the company upon some other basis.

It is contended in the taxpayer's brief and was reasserted at an informal oral hearing before this Committee on April 10, at which the taxpayer was represented by its president, that these amounts, which admittedly constitute a considerable part of the actual working capital of the business, should be, by reason of that fact, regarded as a part of the invested capital of the business within the meaning of the Revenue Act of 1917. In support of this contention the taxpayer advances the argument that these credits and the funds representing them have been regarded as a part of the capital of the corporation by the banks with which it does business and which loan it large amounts of money by reason of these credits as well as by its other large commercial creditors.

The taxpayer contends that the intent of these stockholder-creditors, rather than the letter of the law, should prevail in the consideration of this case and that the good faith behind such intent has been amply and conclusively demonstrated by the fact that these amounts have been left in the business over a period of more than 10 years, to the actual and material financial detriment of these creditors by reason of the fact that the funds representing these amounts have been actively and continuously used in the conduct of the business and in earning profits for the stockholders, from which profits these creditor stockholders derive no advantage beyond the general pro rata participation in the earnings enjoyed by all the stockholders alike.

The taxpayer further contends that it should not be penalized in 1917 merely because of its failure to have made a "book entry," converting these credits into capital stock.

The Committee has given due and earnest consideration to all the facts in this case and to the arguments presented by the taxpayer; but it can not see its way clear to accept the taxpayer's views.

Under section 207 as quoted above, these credits are, in law, obviously either borrowed money or earned surplus and undivided profits. The very purpose for which and the circumstances under which they were created excludes them from consideration as "surplus and undivided profits." It was to determine exactly the equities of these three stockholders in the profits or surplus, until that time undivided, that these credits were established. The president of this corporation vigorously denies that they are "surplus" of the

company in the sense that all the present stockholders have a right to share in them ratably, and admits that these rights of these three stockholders would be asserted as against the other stockholders, though not against the general creditors. That being true, they form no part at all of the "surplus" of the corporation, and the alternative that they are borrowed money can not be escaped.

Article 813 of Regulations 45 provides that—

> Whether a given amount paid into or left in the business of a corporation constitutes borrowed capital or paid-in surplus is largely a question of fact. Thus, indebtedness to stockholders actually canceled and left in the business would ordinarily constitute paid-in surplus, while amounts left in the business representing salaries of officers in excess of their actual withdrawals, or deposit accounts in favor of partners in a partnership succeeded by the corporation, will be considered paid-in surplus or borrowed capital according to the facts of the particular case. The general principle is that if interest is paid or is to be paid on any such amount, or if the stockholder's or officer's 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.

These credits unquestionably rank, in law, with the claims of other general creditors; even though by the good faith and honor of these three stockholders, they would be voluntarily deferred until the claims of the other general creditors had been liquidated in full.

The Committee, moreover, can not concede the corporation's contention that it is being penalized merely because of its failure to have made a "book entry" converting these credits into capital stock; because there can be no doubt that these credits being a direct and fixed obligation of the corporation, have not at all the same status among the corporation's liabilities as would have been the case had they, by formal action of the board, been converted into capital stock and certificates issued therefor, or had the interested stockholders waived all proprietary rights to them and thus actually contributed them to surplus.

Therefore, the Committee is of the opinion that the Income Tax Unit was correct in disallowing as invested capital this amount of 36x dollars and the action of the Unit is confirmed.

SECTION 326.—INVESTED CAPITAL.

SECTION 326, ARTICLE 831: Meaning of invested capital. 1-20-664 A. R. R. 10

> **Held, that the M Company is entitled to include in invested capital only the amounts which have actually been paid to the company for the shares of stock issued and sold to officers and employees of the company under an installment agreement.**

A meeting of the stockholders of the M Company authorized the setting aside of a sufficient number of shares of its common stock for the benefit of such employees as desired to purchase stock under prescribed conditions, and in pursuance of this authority a certain number of shares were so set aside, part of which were taken by an officer of the company and the balance of the stock by other employees. The officer's stock was charged to his personal account, which draws interest. The stock sold to the employees was subscribed for under agreement which permitted payment in cash, part

cash and part deferred payments, or all deferred payments, subject to conditions that payment of subscriptions should be in weekly installments; that deferred payments should bear interest; and that the agreement might be canceled either upon request of the employee, failure to make payments, any attempt of the purchaser to sell his stock or agreement, or resignation or dismissal of the employee prior to the expiration of five years; in the event of any cancellation the employee to receive from the company the full amount of all payments with interest, and, dependent upon the time held more than one year, certain percentages of the difference between the subscription and market price of the stock. Dividends on the stock were to be credited to the subscriber's account as additional payments. In case of cancellation, however, the dividends were not to be credited and the subscriber is not to be charged with interest upon deferred payments.

Upon this statement of fact only so much of the subscription payments as have been actually received by the company may be recognized as invested capital from the date of such receipt. In the case of the officer's stock only so much of the stock as canceled a credit balance in his personal account or was actually paid for by him can be recognized.

SECTION 326, ARTICLE 831: Meaning of invested capital. 3-20-696 A. R. R. 17

Held in the case of a partnership, that stocks owned by the individual partners can not be recognized as invested capital of the partnership even though purchased from profits distributed by the partnership and purchased for the purpose of advancing the interests of the partnership.

The Committee has had under consideration the appeal of a partnership from the findings of the Income Tax Unit in excluding from invested capital stock owned by the individual partners.

The facts appear to be that the taxpayer has the selling agency for the goods of a number of different textile mills and that in order to secure such agency, financing and part ownership of the mills is necessary. In order to effect this the partnership has from time to time turned over to the individuals who composed it sums of money and they have purchased the stocks and bonds necessary on their personal account.

It does not appear from the papers that such purchase was made as agents of the company from funds specifically turned over for that purpose and it is presumed that the funds so turned over are merely a distribution to all interests in the partnership in proportion to their interests of the profits of the company, although such distribution may have been made for the purpose of providing the funds with which the partners might make their purchases. Assuming that this is the case, the Committee is of the opinion that the stocks so purchased are not in any sense assets of the partnership any more than any other assets privately owned by the individual members are assets of the partnership; nor does it appear that they have been so treated in the past on the books of the partnership. The income from such securities has not gone into the income account of the partnership, nor has the amount of the investment in them gone to

increase the amount of capital credited to the partners on which interest is allowed before distributing the balance of profits in accordance with the partnership agreement. It is strongly urged by the taxpayer and may be conceded by the department that the purchase of these stocks is not made for the investment yield, the average return upon the entire amount being approximately five per cent, and that the investments were in fact made for the purpose of securing the selling agencies or business of the mills whose stocks are owned, and that without this financial connection a large part of the profits of the business will be lost.

The fact remains, however, that the law expressly provides what may be regarded as the invested capital of a corporation or partnership, and that is, as affects the question now at issue, the amount of cash or tangible property paid in to the corporation or partnership for stock or *shares*, the share evidently referring to the member's interest in the paid-in capital of the partnership.

The Committee is, therefore, unable to find any warrant of law for recognizing as capital of the partnership property individually owned by members of the partnership, even though such ownership may favorably affect the general partnership interest, and recommends that the action of the Unit in disallowing the amount in question be confirmed.

SECTION 326, ARTICLE 831: Meaning of invested capital. 14–20–838
A. R. R 48

RULING UNDER REVENUE ACT OF 1917.

Amounts added to invested capital in accordance with article 44 of Regulations 41 must be based on the amount of interest for the taxable year which is not allowed as a deduction, and not on amounts disallowed representing accrued interest for prior years.

SECTION 326, ARTICLE 831: Meaning of invested capital. 17–20–881
A. R. M. 43
(Also Section 240, Article 633.)

National banks at times declare dividends which instead of being paid to stockholders are carried with the consent of the stockholders to a stockholders' liability account in the name of a trustee and the amount invested in deals not countenanced by the Comptroller of the Currency. Such stockholders' trustee account, however, is a liability to the individual stockholders, and the assets in which the reserve is invested are the property of the trustee for the stockholders. Therefore, from a technical viewpoint, no part thereof should be included in the invested capital of the bank even though it includes the income from the reserve in its gross income.

Since shares in the bank and in this reserve are on the same pro rata basis, and the stockholders are in fact an association, a consolidated return could be required of the bank and the association, the practical effect of which would be to include the amount of the reserve in the consolidated invested capital and the income from the reserve in the consolidated income. The Committee therefore recommends that the

returns as made, including the stockholders' reserve accounts in the capital of the banks, and the income therefrom in the income of the banks, be allowed to stand. (Note: This memorandum overrules ruling 16–19–466, p. 283, Cumulative Bulletin, December, 1919.)

SECTION 326: ARTICLE 833: Tangible property paid in: evidence of indebtedness. 22–20–980 S. 1391

WAR PROFITS AND EXCESS PROFITS TAX—SECTIONS 325 AND 326, REVENUE ACT OF 1918. INVESTED CAPITAL.

Notes to be paid for only out of earnings accruing on stock for which they are ostensibly given should not be included in invested capital.

Section 325(a) of the Revenue Act of 1918 provides that the term "invested capital" as used in the Act shall include notes. The by-laws of the M Company, a corporation organized under the laws of the State of Oregon, provide that no one shall be allowed to hold stock in the corporation who is not actually identified with and devoting his entire time and talents to the interests of the company, and it is the practice in that company when the services of a desirable person are secured to pay him a nominal salary and issue him shares of stock, for which his enforceable note is taken, the note being paid out of the profits accruing on the stock. The questions are as follows:

(a) Do the laws of the State of Oregon allow issuance of capital stock for (enforceable) notes?

(b) Can the amount of (enforceable) notes outstanding at the beginning of the year be included in invested capital?

(c) Are the notes, given under the conditions named above, enforceable within the meaning of the law as enacted by Congress, and interpreted by the Commissioner to govern invested capital computations?

(a) It is not found that the laws of Oregon specifically recognize the issuance of stock for notes. They do, however, recognize issuance of stock without cash payment. They also recognize the issuance of stock for property, real or personal. Section 6694, Lord's Oregon Laws, provides:

Every corporation organized under this chapter shall keep a stock book in such manner as to show intelligibly the original stockholders, their respective shares, the amount paid, and the amount due thereon, if any * * *.

See also sections 6696 and 6707. If stock may be issued for property or without any payment, it seems clear that it may be issued for notes.

(b) Section 326(a) of the Revenue Act of 1918 provides:

That as used in this title the term "invested capital" for any year means * * *.

(a) Actual cash value of tangible property other than cash, bona fide paid in for stock or shares at the time of such payment * * *.

Under this language it is not sufficient that notes are enforceable. They must be bona fide paid in. This point is discussed more fully in dealing with the next question.

(c) While nothing is found in the statement submitted to show that the notes in question are not legally enforceable, it does not necessarily follow that they are such notes as were contemplated by the framers of the Act as to be treated as invested capital. The law limits includable tangible property to that bona fide paid in. The notes in question are taken from employees, and it is stated by the president of the concern that it is "clearly understood that the notes given as evidence of stock ownership were to be paid wholly from the earnings of such stock and in the event that such employee-stockholder severed his connection with the company, such stock immediately would revert to the company, and the net earnings accrued on same would be immediately paid to him." Notes given under such conditions are not bona fide paid in within the intent of the statute. As indicated by the regulations, article 833, Congress doubtless had in mind notes given in absolute and unqualified payment, notes which are practically equivalent to cash and might be sold for cash, which, in other words, work an increase of the assets of the concern. Here the notes are given only as "evidence of ownership" and no collection thereon is to be made from the employee until he receives or is credited with dividends on the stock for which the notes are ostensibly given. The notes, therefore, add nothing to the resources of the company. There is no increase in its invested capital until it is earned by the company. It would not be consistent with the understanding between the company and the employee to raise money by discounting the notes. Conceivably, the concern might achieve an increase of working capital by borrowing on the notes but, by the express terms of the Act, borrowed money is not admissible. Section 325(a), section 326(b). If such arrangements should be recognized as working an increase of invested capital, invested capital might, at least to the extent of the amount authorized by the company's charter, be increased practically at will. The conclusion reached is that a note to be paid for only out of earnings accruing on the stock for which it is ostensibly given should not be included in invested capital.

SECTION 326, ARTICLE 834: Tangible property paid in: inadmissible assets. 21-20-964 A. R. R. 111

REVENUE ACT OF 1917.

The Committee has had under consideration the appeal of the O Company. This appeal is based on two grounds: One, the action of the Unit in rejecting the claim for assessment under section 210, and the other, the disallowance, in the computation of invested capital under section 201, of an amount of x dollars representing capital stocks of other corporations owned.

At the time of organization, the business having been conducted originally by a partnership, no attention appears to have been given to the actual value of the assets assumed by the corporation, which started business with a capital stock of y dollars, and one of the grounds for the claim under section 210 is this defective accounting. It is understood, however, that in 1912, and again in 1913,

the value of these permanent assets was appraised and written up and stock issued therefor, all of which has been allowed as invested capital. The other ground is that the corporation's income in 1917 was the fruits of previous activities. It is claimed that a large part of the income for 1917 was from a contract undertaken in 1916.

The matter of the company's claim for assessment under section 210 was under consideration by the Tax Reviewers and by them rejected, and the Committee sees no sufficient reason for a reversal of this action. Furthermore, it appears from a statement of the special assessment section that the company's excess profits tax was 41.49 per cent of the income and that statistics obtained from comparison of other corporations engaged in a like or similar business reflect an average tax of 40.14 per cent of the income.

The disallowance of the x dollars of inadmissible assets appears to grow out of the strict interpretation and application of article 44 of Regulations 41. This article, following the provisions of section 207 of the excess profits tax law, provides that "Stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the excess profits tax" may not be included in invested capital. This is merely a statement of the general principle adopted in the Act that borrowed money, interest on which is an allowable deduction, may not be included in invested capital, nor may assets the income from which is not included in the income account, be included. The framers of the Act, however, did not foresee or make specific provision for a situation where inadmissible assets are purchased with borrowed money. It was clearly not the intention of Congress, where, for instance, a corporation has $250,000 of admissible assets, $250,000 of inadmissibles, $250,000 of cash capital and $250,000 of borrowed money, to hold that the corporation has no invested capital, nor does the law so provide *unless* the cash capital is invested in inadmissible assets.

When Regulations 41 were in course of preparation the method of meeting this situation was given very careful consideration and full discussion. It was recognized that in many, if not most, instances, it would be impossible to earmark the dollar paid for inadmissible assets and to say whether it represented invested capital or borrowed money. It was therefore determined to give the taxpayer the benefit of the doubt, and this was done by paragraph 129 of article 53, which, after specifying certain adjustments necessary to be made, provides that the sum so found shall be the invested capital at the beginning of the taxable year, "except that in any case where the admissible assets * * * are less than the amount of such adjusted total, then the invested capital must be further reduced to an amount equal to the sum of the admissible assets." In drafting the form to put into effect this provision it was found to be an awkward thing to accomplish, and precisely the same result was accomplished in the method prescribed by Schedule C 8, Form 1103, and the instructions covering same; that is to say, if the admissible assets are in excess of the adjusted capital and surplus, no further deduction is required because of inadmissible assets; in other words, only the excess of inadmissible assets over total indebtedness is to be deducted from the capital and surplus so found.

Therefore, giving the intended effect to article 53 and to schedule 8(c) of the form, the deduction of x dollars for inadmissible assets,

which is much less than the outstanding indebtedness of the company, was not required, and the action of the Unit in further adjusting the capital and surplus by a reduction for inadmissible assets was erroneous, and the Committee therefore recommends that the corporation be advised to file claim for abatement of the amount of the assessment based on this error, or if claim has already been filed that it be allowed to such extent; and that the action of the Unit in rejecting the claim for assessment under section 210 be sustained.

SECTION 326: ARTICLE 836: Tangible property paid in: value in excess of par value of stock. 21-20-965, S. 1387.

EXCESS PROFITS TAX, REVENUE ACT OF 1917, SECTION 207 (a), REGULATIONS 41, ARTICLE 63.

Time of valuation for the purpose of determining invested capital of property acquired by a corporation by gift.

Where certain commercial leases to oil lands are informally transferred to a corporation formed by the lessees for the purpose of taking over such leases, no consideration being paid for such transfer, it will be deemed that the transfer was made at the time of taking possession, and the addition to invested capital of the corporation upon such transfer is the fair market price or value of the leases at the time possession is so taken by the corporation.

Opinion is requested as to the time when certain commercial leases should be valued for the purpose of determining the invested capital of the M Company which leases were informally transferred to the corporation without consideration by its stockholders.

The Revenue Act of 1917 provides, section 207.

That as used in this title, the term "invested capital" * * * means * * *

(*a*) In a case of a corporation or partnership * * * (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year; * * *.

Interpreting this section article 63 of Regulations 41 provides:

When tangible property may be included in surplus.—Where it can be shown by evidence satisfactory to the Commissioner of Internal Revenue that tangible property has been conveyed to a corporation or partnership by gift or at a value, accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of the cash of the par value of the stock or shares paid therefor, then the amount of the excess shall be deemed to be paid-in surplus. The adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance, but shall be confined to the value accurately ascertainable or definitely known at the time.

Evidence tending to support a claim for paid-in surplus under these circumstances must be as of the date of conveyance, and may consist, among other things, of (1) an appraisal of the property by disinterested authorities, (2) the assessed value in the case of real estate, and (3) the market price in excess of the par value of the stock or shares.

Prior to October, 1913, the M Company was a partnership. This partnership acquired leases to certain oil lands in consideration for its promise to begin drilling wells on the lands leased within a stated period of time, and to continue development. About October, 1913, the partnership instituted proceedings to incorporate. Immediately upon incorporation, and without formal record in any manner, the

commercial leases held by the partnership were turned over to the corporation, which, thereupon, continued the work of drilling wells and developing properties. At the time of this formal transfer to the corporation the leases in question were of a value which can be determined with reasonable accuracy. A few months later, as a result of the development carried on by the corporation, the value of the leases became greatly enhanced.

It is the contention of the taxpayer that since the only way title to the leases could be acquired by the corporation was by fulfilling their individual requirements as to the developing of the properties, the leases were acquired on different dates, that is, the dates when permanent improvements were made by the corporation.

The excess profits tax law of October 3, 1917, authorizes a corporation to include in "invested capital" as paid-in surplus the actual cash value of tangible property made the subject of a gift. Construing this provision, section 207 (a) 3, Regulations 41, article 63, provides that where tangible property has been conveyed to a corporation or partnership by gift or at a value accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of the cash or the par value of the stock or shares paid therefor, then the amount of the excess shall be deemed to be paid-in surplus. That article goes on to state that the adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance, but shall be confined to the value accurately ascertainable or definitely known at that time. Although not definitely authorized by this article, the practice of the Bureau has been to regard as paid-in surplus the entire value of property made the subject of a gift at the date of its "conveyance."

The term "conveyance" is not used in this article in its strict technical sense, but means simply a transfer of the interest of the donor to the donee. This is shown by the fact that the article is concerned with tangible property in general, whereas, as is well known, the term "conveyance" is, strictly speaking, applied only to the formal transfer of real property by deed.

In the instant case it is undisputed that the entire interest of the partnership or the individual members thereof in the leases in question was transferred to the corporation at its date of incorporation.

While it is true that after such transfer of interest the corporation was required to continue the drilling of wells and the developing of the properties in order to carry out the terms of the original leases, still, so far as the partnership, the donor, and the corporation, the donee, are concerned, the entire interest of the former was transferred at the date of incorporation. The conditions which had to be fulfilled by the corporation did not affect the transfer of interest in the leases from the partnership, but simply the maintaining of the property in the leases as originally made.

As a general rule a sale of an interest in real property is held to occur at the time a deed passes or at the time possession and the burdens and benefits of ownership are, from a practical standpoint, transferred to the buyer, whichever occurs first. (See Law Opinion 988; Solicitor's Memorandum 1267, and cases therein cited.) The rule as to the effective date of a gift of an interest in real property for purposes of valuation should be the same as in the case of a sale. Since only the original parties are concerned, this conclusion

is not affected by reason of the fact that the transfer was oral. In the instant case possession of the lands covered by the leases was taken immediately by the corporation; in fact such taking of possession is the only evidence of the transfer. Even if there had been a subsequent written assignment of the leases, such assignment would, for the purpose of fixing valuation, be retroactive to the time when the parties intended the property to pass, i. e. in this instance to the time when the corporation took possession and dealt with the leases as the owner thereof.

It is, therefore, held that where certain commercial leases to oil lands are informally transferred to a corporation formed by the lessees for the purpose of taking over such leases, no consideration being paid for such transfer, it will be deemed that the transfer was made at the time of taking possession, and the addition to invested capital of the corporation upon such transfer is the fair market price or value of the leases at the time possession is so taken by the corporation.

SECTION 326, ARTICLE 837: Surplus and undivided profits; paid-in surplus. (Also Section 213 (a), Article 50.) — 12-20-801 O. D. 417

So much of a replacement fund for steamers lost established in accordance with article 50, Regulations 45, as represents excess of the amount of insurance received over the book value of the steamers at the time of their destruction may not be included in invested capital for the purpose of war and excess profits taxes, even though the interest received from the investment of such excess is reported as taxable income, because such excess is not "paid-in or earned surplus" within the meaning of section 326 of the Revenue Act of 1918.

SECTION 326, ARTICLE 837: Surplus and undivided profits: paid-in surplus. (Also Section 327, Article 901.) — 17-20-882 A. R. R. 70

REVENUE ACT OF 1917.

The principal stockholder of a close corporation invented a certain article and turned over to the corporation his rights to the invention. After some litigation, a patent was granted to the inventor who turned it over to the corporation without consideration. The corporation was engaged in the manufacture and sale of the article both before and since the patent was issued. The questions presented are whether the value of the patent may be included by the corporation in its invested capital for 1917, since it was not paid in for stock but without consideration, and assessment of its excess profits tax for 1917 under section 210 of the Revenue Act of 1917.

Section 207 of the Revenue Act of 1917, defining invested capital, provides for three classes of such capital, following the earlier Act of March 3, 1917, as actual cash paid in, tangible property paid in for stock or shares, and paid in or earned surplus. Then follows a proviso not contained in the Act of March 3, 1917, providing for two

classes of property as to the classification of some items of which there has been, in the courts of the country, considerable dispute. The first provides that the actual cash value of patents and copyrights paid in may be included in invested capital not to exceed the par value of stock issued therefor; the second provides that good will, trade-marks, trade brands, etc., may be taken into invested capital only to a limited extent as intangible property. It will be seen by this division that Congress manifestly intended in the Revenue Act of 1917, to classify patents and copyrights as tangible property and trade-marks, good will, and other property as intangible; and it also provided that where patents were turned in *for stock* the figure at which they could be taken into invested capital is the actual cash value or the par value of the stock issued therefor, whichever is lower, but this does not necessarily preclude the recognition of actual value of patents turned in as paid-in surplus.

The Committee is therefore of the opinion that under the Revenue Act of 1917, the corporation would be entitled, upon establishing the value of the patent turned over to the company without consideration, to include such value as invested capital. In the present case, however, it is apparent that the inventor turned over to the company the rights to his invention long prior to the issuance of letters patent covering same, in fact, immediately after the invention of the device. The amount which could be recognized, therefore, as paid in surplus would be the value of the invention at the time it was turned over to the company and before commercial development rather than its value when letters patent were issued and at which time development had proceeded sufficiently to possibly justify the valuation claimed by the company. What that value was at the time of the invention is, in the judgment of the Committee, a fact which can not be satisfactorily determined, and it seems clear that it would be impossible to prove a value at that time in excess of the value given to it in practical effect by the application of section 210; that is to say, the difference between the statutory capital and the constructed capital under that section.

The Committee is therefore of the opinion that the action of the Income Tax Unit in assessing the tax under the provisions of section 210 was proper and works no injustice upon the taxpayer.

For the same reasons that section 210 was applied under the 1917 Act, it is recommended that the company be assessed for 1918 and subsequent years under the provisions of sections 327 and 328 of the Revenue Act of 1918.

SECTION 326, ARTICLE 837: Surplus and undivided profits: paid-in surplus. 19–20–925 A. R. R. 86

REVENUE ACT OF 1917.

Held in the appeal of the M Company that a claim for paid-in surplus in 1917 can not be allowed in the case of appreciated value in a leasehold which was acquired by the company as original lessee without cost and which was not paid in at a fixed value for stock or shares.

The M Company has appealed from the decision of the Income Tax Unit in connection with its income and excess profits tax for

1917. Amended returns were filed by the company, in which the invested capital for 1917 was increased by including therein as paid-in surplus the appreciated value of a lease, which was acquired by the company as original lessee, and which was not paid in for stock or shares in such company. This leasehold was not carried as an asset by the company, and was not entered on its books until 1918.

It appears that subsequent to the time of filing its return, and during the early part of 1919, the company had an appraisal made for the purpose of fixing the value of this leasehold. This appraisal furnishes estimated values as at the time of the renewal of the lease in 1916, and values for years subsequent thereto. The company claims in its presentation of the case that article 63 of Regulations 41 permits the inclusion in invested capital as paid-in surplus the appreciated value of the leasehold as ascertained by the appraisal. The original lease, which was acquired without cost, carried an option of renewal, which was exercised by the company in 1916. This renewal, under the option of the original lease, was obtained without cost.

The term "invested capital" as used in the excess profits tax law for 1917 means the invested capital of the present owner. The starting point in the computation of invested capital is the amount of cash and other property paid in. In the ascertainment of the correct invested capital, surplus and undivided profits are taken into consideration, and also depletion, depreciation, or obsolescence of the property originally acquired for cash, or for stock or shares, or in any other manner.

The taxpayer relies on the provisions of article 55 of Regulations 41, reading 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 is one of the few cases in which the law permits allowance to be made for appreciation, and here no appreciation can be recognized unless the original stock or shares were specifically issued in exchange for such tangible property.
>
> Tangible property paid in for stock or shares on or after January 1, 1914, will be taken at the actual cash value of such property at the time of payment, irrespective of the par value of the stock or shares.

The taxpayer also relies on the provisions of article 63, which read as follows:

> Where it can be shown by evidence satisfactory to the Commissioner of Internal Revenue that tangible property has been conveyed to a corporation or partnership by gift or at a value, accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of the cash or the par value of the stock or shares paid therefor, then the amount of the excess shall be deemed to be paid in surplus. The adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance, but shall be confined to the value accurately ascertainable or definitely known at that time.
>
> Evidence tending to support a claim for a paid-in surplus under these circumstances must be as of the date of conveyance, and may consist, among other things, of (1) an appraisal of the property by disinterested authorities, (2) the assessed value in the case of real estate, and (3) the market price in excess of the par value of the stock or shares.

The Committee in the consideration of this case has applied the law to the statement of facts and is of the opinion that the instant

case does not fall within the provisions of articles 55 and 63 as contended by the taxpayer.

The articles of the regulations quoted above are specific and correctly interpret the statute. The taxpayer, by its admission, bars any claim for paid-in surplus. The company having acquired the leasehold as original lessee without cost and later renewing same without cost had nothing which could be paid in for stock or shares. Any value appreciation in such leasehold must be eliminated from the computation of invested capital.

SECTION 326, ARTICLE 838: Surplus and undivided profits; earned surplus. 18–20–906 A. R. R. 71

The Committee is of the opinion that appreciation is in no event a part of earned surplus and therefore can not offset depreciation in the value of assets through wear, tear, and exhaustion. Depreciation must first be figured in order to determine true earned surplus. In other words, earned surplus is believed to consist of realized gains or profits and while such realized gains or profits must be reduced by any depreciation in value through use or exhaustion of the assets in which they are invested, any appreciation in value of those assets which is not yet realized can not be taken into consideration for the purpose of offsetting such decrease.

A corporation owns patents covering certain inventions made by its employees. The cost of securing the patents and the salaries of the employees whose inventions were patented were paid by the corporation and charged to expense account. The corporation may not include in its invested capital any amount representing either the cost of the patents or appreciation in their value.

SECTION 326, ARTICLE 840: Surplus and undivided profits: additions to surplus account. 19–20–926 A. R. R. 100

REVENUE ACTS OF 1916 AND 1917.

In re: Additional income and excess profits taxes for 1917 and 1918 and munition taxes for 1916 and 1917 assessed against the M Company.

The Committee has had under consideration the informal appeal of the M Company against the assessment of additional income and excess profits taxes for 1917 and 1918 and of munition taxes for 1916 and 1917.

Four questions were raised by the taxpayer: (1) Liability to munition taxes; (2) value of assets turned over to the corporation on organization; (3) a deduction taken in 1918, covering so-called copper replacement liability; and (4) losses upon the sale of the property. The Unit concedes the correctness of the deduction for loss on the sale of the property, and upon the argument of the case before the Committee the appeal relative to the copper replacement liability was abandoned by the attorney for the company, leaving only two questions to be decided.

The company claims that it manufactured copper bands from copper owned by the Government. There is no denial that the copper bands so manufactured were parts of munitions and the only question is whether or not the company comes within the decision of the Solicitor in S. 116 and Law Opinion 573. In both of these cases the taxpayers did not own the munition material but merely performed work upon it, and in the first case the Solicitor held that the taxpayer was not subject to tax because it did not change the form, quality, property, or combination of the material upon which it performed work, while in the second case the taxpayer was held subject to the tax because it did change the form of the material.

In Law Opinion 573 the Solicitor held that—

> The test of whether a person is a manufacturer of parts of munitions within the meaning of Title III of the Act of September 8, 1916, is not whether he performed labor under contract upon raw materials, furnished by another but whether he gave new forms, qualities, properties, or combinations to raw or prepared materials;

and in effect he held in Solicitor's Memorandum 116 that the claimant had a bailee's interest in the castings which it manufactured and that it parted with this interest under its contract with the bailor when it received the compensation provided for by the contract. It is conceded that the company received copper from the bailor and that it returned to the bailor copper rings distinctly different from the form in which it received the material.

In a recent case decided by the Supreme Court, the *Carbon Steel Co.* v. *Lewellyn*, the court used the following language:

> It was such profits that the Act was intended to reach—profits made out of the war and taxed to defray the expense of the war. Or, as expressed by the Court of Appeals, Congress "felt that the large abnormal profits incident to these war contracts created a remunerative field for temporary taxation."

In view of the facts in this case the Committee is of the opinion that the munition taxes were properly assessed against the company, and recommends that the decision of the Unit be sustained.

The second question relates to invested capital. It appears that A, in the early part of 1916, purchased the plant and sundry assets for $11x$ dollars, and that in September, 1916, after rearranging and modifying the machinery and equipment and securing contracts for the manufacture of shell rings, sold the property to the M Company, receiving payment therefor in stock, the revenue agent stating that 2,750 shares of the total issue of 3,000 were turned over to A for this property. It is presumed that the other 250 shares were issued for cash, and upon the theory that the assets turned in for stock under such conditions had an actual cash value equal to the par of the stock issued therefor, the value of tangibles and intangibles acquired from A would be $14x$ dollars. Claim is made that the value of the intangibles was increased by A after the purchase by himself by reason of his personal services as an engineer in developing the property and perfecting certain processes for which he did not credit himself when constructing the plant and organizing the business.

The Unit concedes that so much of the increased value as represents actual additions and betterments to the plant may be regarded as invested capital and in this view the Committee concurs. However, in the absence of proof as to additions and betterments made,

the Committee is of the opinion that the difference between the purchase price of 11æ dollars in the early part of 1916 and the selling price in September, 1916, constitutes an intangible asset or good will subject to the 20 per cent limitation under the 1917 Act.

The Committee therefore recommends that the action of the Unit with respect to invested capital be sustained.

SECTION 326, ARTICLE 841: Surplus and undivided profits; limitation of additions to surplus account. 2–20–679 A. R. M. 12

(Also Section 327, Article 901.)

At the request of the Commissioner this Committee has given an oral hearing to representatives of the proprietary medicine manufacturers in general, and of the M Company in particular, upon the question of an addition to invested capital through the recognition of a portion of the amounts spent in prior years for advertising and developing trade-marks and trade brands.

It was stated at the hearing that the methods pursued by the company named above are essentially similar to those followed by many other manufacturers engaged in the same industry, and that this case is a typical one. The asset of greatest value of the M Company is a formula and trade-mark. When this asset was acquired, the product had a certain sale in limited territory. Profits from the sale of the product were reinvested in development of new territory. For instance, if the company decided that it would undertake to develop any territory where it had previously sold no goods, it would institute an intensive advertising campaign in that territory by newspaper and other advertising agencies, distribution of samples, etc. The next year some other territory would be chosen. During this period of development it is claimed that the amount expended in advertising in a given territory was far in excess of the profits made from sales in such territory, and it is therefore claimed that a portion of all such expenditures is in reality a capital investment and not merely expense of selling, since it is an investment from which returns are to be expected in the future rather than in the immediate present. It must be conceded that in theory some proportion of all advertising is in effect the building up of good will, but it is the judgment of the Committee that it is impossible to allocate any definite percentages as between capital investment and selling costs.

It seems clear to the Committee that no court would permit the disallowance of a proportion of reasonable advertising in a return of income on the ground that such advertising was a capital investment and not an actual necessary expense of business, and if that be true the converse must follow, namely: that the corporation can not claim that any proportion of such expense is capital investment and not business expense.

It was also brought out at the hearing that there have been a number of widely advertised trade-marks of this character sold within recent years and that such sales were usually made upon the basis of approximately a five-year return; that is to say, for a price five times the annual earning capacity. There are, therefore, satisfactory comparatives in the event that it is desired to treat other

cases where there have been no sales as special cases under sections 327 and 328, since the cash paid for tangibles and intangibles affords a fair invested capital basis. It also seems reasonable to regard those cases where large sums have been spent in advertising, thereby creating a good will or earning capacity far in excess of recognizable invested capital, as being cases in which there are abnormal conditions affecting invested capital.

The Committee therefore recommends that the percentage of tax to income in the cases of those corporations which have an adequate recognizable invested capital be determined, and that other cases which have no such invested capital be regarded as coming within the scope of section 327 and the tax properly to be computed under section 328.

SECTION 326, ARTICLE 845: Surplus and undivided profits: reserve for income and excess profits taxes. 11–20–788 O. D. 410

(Also Section 328, Article 911.)

Where a corporation has filed a claim for determination of war-profits and excess profits tax for 1918 under section 328 and has made payments on the basis of 50 per cent of the net income, the claim not having been acted upon when its 1919 return is due, the invested capital for 1919 should be adjusted on the basis of the tax payments actually made, subject, however, to readjustment when the correct amount of tax for 1918 is determined

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SECTION 326, ARTICLE 846: Surplus and undivided profits: insurance on officers. 21–20–966 O. D. 524

In case a corporation beneficiary has deducted from gross income only a portion of the premiums paid in prior years on insurance policies on the lives of its officers or employees, it may include in its invested capital for the taxable year the same proportion of the cash surrender value of the policies on January 1, 1917, that the premiums paid and not deducted from gross income bear to the total premiums paid to that date. The computation of this proportion relates only to premiums applicable to the years prior to January 1, 1917, and can not be made with respect to any premiums paid subsequently for the reason that under the Revenue Acts of 1917 and 1918 premiums paid by a beneficiary corporation on the lives of its officers and employees are not allowable deductions from gross income.

If all premiums paid prior to 1917 have been deducted from gross income, only the increase in the cash surrender value of the policies from January 1, 1917, to the beginning of the taxable year may be included in invested capital.

SECTION 326, ARTICLE 851: Intangible property paid in. 1–20–665 A. R. R. 9

A and B, who own most of the stock of the M Company, invented certain machinery, for which patents were issued to them. The

cost of obtaining these patents was paid by the company. It does not appear whether at that time the patents were formally assigned to the corporation, but, in all events, the corporation had the use of the patents as though they were its own, without compensation to the inventors. The patents at that time being undeveloped, their value was, of course, problematical, but by 1916 they had been sufficiently developed to prove of considerable value.

In 1916 the corporation desired to increase its capital, and in order to do so, the patents in question were put upon the books at a value of $2x$ dollars and a stock dividend was declared.

Upon the basis of the above statement of facts the Committee is clearly of the opinion that the patents were not specifically paid for by the issuance of stock, nor by any payment of cash. They were apparently treated as though they belonged to the corporation which had paid the cost of their issuance from the time of issuance, and it is not shown that anything was paid for them at the time other than cost, nor that they had any value at that time in excess of cost. Even assuming that they were not formally assigned until 1916, it does not appear that any stock was issued in payment therefor, except such stock as was issued as a stock dividend to all stockholders, including those who had no interest in the patents, as well as to the original patentees.

The conclusion reached, therefore, is that the value of the patents as carried upon the books, $2x$ dollars, can not be included in invested capital, and that the decision of the Income Tax Unit must be affirmed.

SECTION 326, ARTICLE 851: Intangible property paid in. 9-20-776 A. R. R. 29

RULING UNDER REVENUE ACT OF 1917.

Held, that the M Company can not include in its invested capital for 1917 an amount representing secret formulas paid in for stock or shares in excess of 20 per cent of the outstanding capital stock of the company on March 3, 1917.

The M Company was organized in 1909, with an authorized capital stock of $10x$ dollars, which was issued for—

Cash	x dollars
Secret formulas	$9x$ dollars

On July 1, 1917, the company issued additional stock of the par value of $90x$ dollars for—

Cash	$5x$ dollars
Capitalization of good will	$40x$ dollars
Appreciation in value of secret formulas	$45x$ dollars

The record in the case does not show whether this increase of $90x$ dollars in capital stock was made through the appreciation of assets and the declaration of a stock dividend, but it appears that this method of increasing capital stock has been used. The appreciation in the value of the processes was largely due to the further development of the formulas. The cost of this development was paid by the company and deducted as business expenses.

In the computation of changes in invested capital, Schedule D, Form 1103, for the year 1917, the company eliminated the item of

$40x$ dollars on account of good will, but claimed that the balance of $50x$ dollars should be prorated for six months and $25x$ dollars admitted as an addition to invested capital. The return was prepared on that basis.

An examination of the return for 1917 shows that the company sustained a loss for 1911 and made profits in 1912 and 1913 and that the $90x$ dollars increase in capital stock was made as of July 1, 1917, and distributed pro rata to the various stockholders on the basis of their respective stockholdings, thus indicating that the increase in capital stock was made through the distribution of a stock dividend.

In the audit of the return for 1917 the Income Tax Unit rejected the claim for addition to invested capital in the amount of $25x$ dollars and allowed the prorated amount of $5x$ dollars cash paid in July 1, 1917. The Unit also allowed 20 per cent of the capital stock outstanding on March 3, 1917, as representing the secret formulas.

In the presentation of the case, it was strongly argued that the secret formulas are tangible property; that the Unit was in error in disallowing $7x$ dollars of the capital account in order to conform with the limitation prescribed by the statute and that the total amount of $25x$ dollars should have been allowed to stand for the reason that the secret formulas had a value greatly in excess of the value used when they were turned in to the company for stock at the time of its organization. The value can not be fixed for the secret processes at the time they were paid in for stock; neither can the cost of development be established. The company urges that since A, a stockholder, was able to sell x dollars of stock at par the $9x$ dollars retained by him was worth par, thus establishing the value of the processes at the time they were paid in for stock. It should be noted a great deal of stress is laid upon the value of the processes.

It is claimed further that the increase in value of secret processes, is due to the fact that they had previously been carried at a low valuation on the books, and that the earnings of the company depend to a very large degree on these secret processes and formulas, which are being constantly improved year after year for the benefit of the business. It was deemed, therefore, only fair that such processes be carried at a value which more truly represents their earning power, as compared with the other tangible assets of the business.

While it is not so stated, it would indicate that a stock dividend was declared against the appreciated assets of the company. The conference had with the attorneys tends to substantiate this view. If this be true, then the principle that the distribution of a stock dividend does not increase nor decrease invested capital would be applicable.

The question as to whether or not the secret formulas can be considered as tangible property is presented. Section 207 of the Revenue Act of 1917 provides in part as follows:

* * * the good will, trade-marks, trade brands, the franchise of a corporation or partnership, or other intangible property, shall be included as invested capital if the corporation or partnership made payment bona fide therefor specifically as such in cash or tangible property, the value of such good will, trade-mark, trade brand, franchise, or intangible property, not to exceed the actual cash or actual cash value of the tangible property paid therefor at the time of such payment; but good will, trade-marks, trade brands, franchise of a corporation or partnership, or other intangible property, bona fide purchased, prior to March third, nineteen hundred and seventeen, for and with interests or shares

in a partnership or for and with shares in the capital stock of a corporation (issued prior to March third, nineteen hundred and seventeen), in an amount not to exceed, on March third, nineteen hundred and seventeen, twenty per centum of the total interests or shares in the partnership or of the total shares of the capital stock of the corporation, shall be included in invested capital at a value not to exceed the actual cash value at the time of such purchase, and in case of issue of stock therefor not to exceed the par value of such stock.

Article 47 of Regulations 41 provides:

The term "other intangible property" as used in section 207 will be construed to mean property of a character similar to good will, trade-marks, and the other specific kinds of property enumerated in the same clause. * * *

Articles 57 and 58 of Regulations 41 provide respectively as follows:

If good will, trade-marks, trade brands, franchises of a corporation or partnership, or other intangible property has been purchased with stock or shares issued prior to March 3, 1917, the amount that may be included in invested capital must not exceed (a) 20 per cent of the par value of the total stock or shares outstanding on that date, nor (b) the actual value of the asset at the date acquired, nor (c) the par value of the stock issued in payment for the asset.

The 20 per cent limitation upon intangible property purchased prior to March 3, 1917, for or with stock or shares of the corporation or partnership, applies not to each item or class of intangible property separately, but to the aggregate amount of all such property so purchased. Such intangible property may be included in the invested capital only up to an amount not exceeding 20 per cent of the total stock or shares of the corporation or partnership on March 3, 1917, even though the aggregate amount of such intangible property be greater in value than such 20 per cent of the par value of the total stock or shares.

Intangible property bona fide purchased prior to March 3, 1917, with stock having no par value may be included in invested capital at a value not exceeding the actual cash value of such intangible property at the time of the purchase and in an amount not 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.

The Advisory Tax Board in Memorandum 5 (Cumulative Bulletin, December, 1919, page 286), recommended that Ruling 24 issued by the Tax Reviewers, interpreting article 58 quoted above, be amended to read as follows:

Twenty per cent limitation upon intangible property in cases where capital stock has been increased or reduced.—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 will be based upon the par value of the total stock outstanding on March 3, 1917.

It appears to the Committee that the value of the formulas at the time the company was organized was apparently largely speculative and any increase in value through subsequent development could not properly be included by way of an addition to invested capital.

After consideration of all the facts presented on the questions at issue and the definition of the term "intangible property" as used in the Revenue Act of 1918, the Committee has reached the conclusion that the secret formulas cannot be considered tangible property, and that additions to invested capital in 1917 through revaluation of the intangible assets cannot be permitted under the law and the regulations. Therefore, it is recommended that the decision of the Unit be confirmed.

SECTION 326, ARTICLE 858: Effect of ordinary dividend. 20-20-943 A. R. M. 51

REVENUE ACT OF 1917.

The Committee is in receipt of a request for advice upon certain points, which have been raised in connection with the audit of the return of the M Copper Company, and in connection with the audit of other copper companies.

It appears that during the year 1917, and prior to August 6, 1917, the M Company paid a dividend of approximately x dollars, which was declared to have been paid out of earnings accumulated prior to March 1, 1913. At the date of the dividend payment the excess of depletion allowable for 1917 on the basis of March 1, 1913, over the depletion actually sustained on the basis of cost, was an amount in excess of the dividend declared to have been paid out of earnings accumulated prior to March 1, 1913. The M Company therefore contends that before any impairment of invested capital as of December 31, 1916, is determined because of the dividend payment, there should be taken into consideration the realization of the appreciation in values as of March 1, 1913, which has been converted into cash and reflected on its books during the current year.

The question in connection with the other copper companies involves essentially the same point without the complication of the dividend. In the opinion of the Committee, neither contention is well taken. The M Company having by appropriate action declared the dividend out of earnings accumulated prior to March 1, 1913, and so advised its stockholders, will not now be heard to say that the dividend was actually paid out of earnings of the current year, and as will be subsequently developed in this memorandum the Committee is clearly of the opinion that appreciation prior to March 1, 1913, realized in the taxable year, is an earning of the taxable year and not an earning accumulated prior to March 1, 1913.

In the Baldwin Locomotive case (*Baldwin Locomotive Works* v. *McCoach*, 221 Fed. 59) it was held that appreciation in values is not earnings or profits until realized. This decision was rendered under the Act of 1909, and following it no appreciation in the value of corporate properties to March 1, 1913, was reported or tax paid as income or earnings notwithstanding the Act of October 3, 1913, gave to such corporations the right to fix value as of March 1, 1913, including appreciation, as the basis for any subsequent gain or loss.

Following this decision and the decisions of the Supreme Court as to the taxation of appreciation to March 1, 1913, it is clear that the realization of such appreciation is an earning of the year in which such appreciation is realized, although under the latter decisions it is not a taxable earning. Since the excess profits tax law definitely holds that earnings of the taxable year are not to be included in earned surplus or undivided profits, realization of appreciation in values to March 1, 1913, is not a proper addition to invested capital as the realization takes place, as contended for by the companies.

It is therefore held that the dividend payment of the M Company must be deemed to have been paid from earnings or profits realized prior to March 1, 1913, and therefore that the invested capital of the

company must be reduced by that amount; and secondly, that realization during the taxable year of appreciation in values to March 1, 1913, can not be included in the invested capital of the taxable year.

SECTION 326, ARTICLE 862: Purchase of stock.

(See 18–20–891; sec. 201, art. 1548.) Effect of retirement of capital stock on invested capital.

SECTION 327.—SPECIAL CASES.

SECTION 327, ARTICLE 901: Treatment of special cases.

(See 2–20–679; sec. 326, art. 841.) Application of section 327, Revenue Act of 1918, in cases where good will has been built up by the expenditure of large sums in advertising.

SECTION 327, ARTICLE 901: Treatment of special cases. 5–20–722 A. R. R. 19

Held in the appeal of A that the excess profits tax as assessed by the Income Tax Unit under section 210 of the Revenue Act of 1917, is correctly assessed.

The firm of A is engaged in the produce commission business, but a proportion of its income is derived from buying produce outright and selling it for its own account. This proportion, however, is entirely problematical and speculative.

The Committee finds difficulty in arriving at the facts in this case for the reason that it is apparent from the papers submitted that the books of the partnership are not kept with precision. Nevertheless from the balance sheets submitted by the firm and from its own statements it appears that it was in the enjoyment of a "substantial credit" in addition to the capital invested by the partners. It appears certain that the income of the firm was derived about evenly from commissions on sales of produce belonging to others and from profits on sales of produce purchased for its own account.

Under these circumstances the firm is not entitled to consideration under Section 209 of the Revenue Act of 1917.

Article 73 of Regulations 41 provides that—

Commission houses regularly employing a substantial amount of capital, whether to lend to principals or to carry goods on their own account, are not deemed to be agents or brokers and are taxable under the provisions of article 16.

Article 74 of the same regulations provides that—

The following will not be construed as businesses having a nominal capital for purposes of excess profits tax; (b) corporations which, although their capitalization is nominal, employ a substantial amount of capital in their business.

The Committee is of the opinion that the facts, so far as they are known or asserted by the taxpayer, construed in the light of the regulations above quoted, clearly exclude the taxpayer from what-

ever benefit might be derived from the application of section 209 of the Revenue Act of 1917, and therefore the Committee recommends that the appeal of the taxpayer for consideration under such section be denied and that the action of the Income Tax Unit in assessing tax under Section 210 of the above Act be approved and confirmed.

SECTION 327, ARTICLE 901: Treatment of special cases.

(See 10–20–783; sec. 311, art. 783.) Consideration of section 327 in connection with cases where the median (sec. 311(c)) is used in computing the war profits credit.

SECTION 327, ARTICLE 901: Treatment of special cases.

(See 17–20–882; sec. 326, art. 837.) Application of section 210, Revenue Act of 1917, and sections 327 and 328, Revenue Act of 1918, in cases where the principal asset of a corporation is an invention of unknown value.

SECTION 327, ARTICLE 901: Treatment of special cases. 19–20–927 O. 1000–A

The provisions of section 327(d) of the Revenue Act of 1918 are applicable to cases of hardship caused by abnormal conditions affecting the capital or income of the corporation for the prewar period or for the taxable year.

A reconsideration of Law Opinion 1000, in which it is decided that the provisions of section 327(d) of the Revenue Act of 1918 do not apply where hardship is caused by some abnormal condition affecting the capital or income of the prewar period of the corporation, has been requested. Section 327(d) provides as follows:

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without the benefit of this section would, owing to *abnormal conditions affecting the capital or income of the corporation*, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned *within the taxable year* a high rate of profits upon a normal invested capital nor (2) in which 50 per cent or more of the gross income of the corporation *for the taxable year* (computed under section 233 of Title II) consist of gains, profits, commissions, or other income derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

This subdivision is not in terms limited in its application to cases arising out of abnormal conditions affecting the capital or income of the corporation *for the taxable year*. The words "capital or income of the corporation" are general words applicable to the income or capital of any year and can not be limited by construction unless there is a clear, necessary, and irresistible implication from other parts of the Act that such a limitation should be made. *Faw*.

v. *Marsletter*, 3 Cranch, 10, 23; *United States* v. *Coombs*, 12 Peters, 72, 80. Furthermore, in the same subdivision Congress has in two instances specified that the income or profits referred to is that of the taxable year, although the context made that meaning clear without specification. The use of such a limiting clause in two instances and the absence of it in the third instance indicates that the words were there used without limitation. Therefore, unless there is some clear and necessary inference from the other parts of the statute, it seems evident that subdivision (d) includes cases of hardship caused by abnormal conditions affecting the capital or income for the prewar period.

The prewar data is used in computing the war profits credit. Section 311 defines the war profits credit. It may consist of (a) $3,000 plus the average net income for the prewar period with an adjustment for changes in capital; or (b) $3,000 plus a percentage of the invested capital for the taxable year based on the median average established by the prewar experience of a general class of trade or business. This credit is used by concerns having no prewar history; or (c) a minimum war profits credit of $3,000 plus 10 per cent of the invested capital for the taxable year.

It is suggested that because of the minimum war profits credit provided for in section 311(b) in case a corporation had no income in the prewar period or earned less than 10 per cent of its invested capital, it should be presumed that Congress intended to include in section 311 all relief which should be granted because of abnormal conditions existing in the prewar period, and that there is a clear and necessary inference that Congress did not intend to grant further relief of the same nature under section 327 on account of the same conditions.

It should be noted, however, that the relief granted in section 311 and that granted in section 327 are not of the same nature. Section 311 establishes certain rules applicable to general classes and which apply in all cases whether hardship actually exists or not. It gives relief to industries which passed through a period of depression in the prewar years. It also applies to concerns which earned less than 10 per cent in the prewar period, even though their tax is not grossly disproportionate to that of their competitors. Neither of these cases would be helped by section 327.

Section 327 on the other hand deals not with general classes but with specific instances and grants relief in special cases according to the facts of each case where, without such relief, there would be a hardship as compared with representative concerns because of some abnormal condition affecting the capital or income of the corporation. The two sections are of a different nature. Section 311 would give no relief to a corporation belonging to a class which normally earned 20 per cent if that corporation, due to some abnormal condition affecting the income of the prewar period, earned only 12 per cent during the prewar period. Such concerns do not receive even partial relief under section 311. They would receive relief under section 327 if that applies. Section 311 lays down a number of general rules applicable to general classes which apply in all cases without reference to their effect. Section 327 deals with specific cases and applies only where the failure to give relief will cause hardship.

These sections have different purposes, apply to different classes of cases, and measure the relief in a different way. In my opinion, the fact that they may both affect the same case does not make section 311 exclusive in that case.

It is concluded that the fact that the general rules established by section 311 will in some cases grant partial relief against an abnormally low income in the prewar period, does not clearly and necessarily limit the application of section 327 to cases of hardship arising out of abnormal conditions affecting the capital and income for the taxable year only. No other reason has been suggested for limiting the literal interpretation of the general words used in section 327(d). They should, therefore, be given their ordinary and natural meaning so that section 327(d) will apply to cases of hardship due to abnormal conditions affecting the capital and income of the prewar period or of the taxable year.

SECTION 327, ARTICLE 901: Treatment of special cases. 20–20–944
A. R. R. 104

REVENUE ACT OF 1917.

During its fiscal year, which ended May 31, 1911, this corporation commenced the erection and operation of a refinery wherein the crude product manufactured by it could be refined and made into high-grade finished products, thus adding a new department to its business which had theretofore been confined to purchasing and manufacturing the raw material into the finished product as above outlined and selling the residue of the raw material.

The building of this additional plant and the experimental operation and development of this new line of business extended over several years, requiring the withdrawal from its other lines of business of a large share of the corporation's available capital, thus greatly curtailing its earning power and reducing its profits for these years in which this experimentation and development was in progress, and requiring, also, the investment of a considerable portion of its working capital, so withdrawn from its other lines of industry, in real estate, buildings, machinery, etc., and necessitating the spending of the remainder for supplies and accessories to the refinery business; and in advertising, and in other ways exploiting the particular trade brands adopted by this company for its finished product.

It is set forth in the corporation's brief that all of the capital thus required and so employed was, for the time being, unproductive; but that it was of necessity included on its books of account and in its annual statements as a part of its invested capital; that it not only earned nothing and thereby reduced the percentage of profit for the business as a whole; but for practically all of the time designated as the "prewar period," this development and these expenses resulted in an actual loss in its refinery business.

In support of this contention the corporation submits a statement from which it appears that its earnings on the capital actually invested in its business, exclusive of the refinery, during the prewar period, were at the rate of 11.1 per cent of the capital so invested,

and in addition it submits a statement of the annual earnings of its business as a whole from June 1, 1898, to May 31, 1918, which statement follows:

Percentage of earnings to investment.

Year ended May 31:	Per cent.	Year ended May 31:	Per cent.
1899	27.5	1909	40.6
1900	24.8	1910	16.4
1901	----	1911	3.5
1902	61.9	1912	16.8
1903	48.7	1913	1.2
1904	21.7	1914	13.0
1905	22.2	1915	11.6
1906	23.2	1916	1.4
1907	21.9	1917	44.5
1908	19.6		

From this statement it appears that during the period to and inclusive of the year 1910 the earnings never fell below 16.4 per cent on its invested capital (except in the year 1901, when there was a loss) and ran as high as 61.9 per cent in 1902, the average for the 12 years being 26.1 per cent.

In computing the tax of this taxpayer for the year 1917, the Income Tax Unit applied the provisions of sections 203 and 205 of the Revenue Act of 1917 and established comparisons with corporations with capital between $1,000,000 and $1,500,000 which were engaged in a similar line of business. In this classification were found only three corporations beside the taxpayer, and the earnings of these were about 7 per cent of their invested capital. From this comparison by the Unit the taxpayer appeals on the ground that the corporations selected are not representative so far as its business is concerned, for the reason that none of them engages in all the different lines of activities which comprise the business of the taxpayer, and also on the ground that its own average earnings of 26.1 per cent over a period of 12 years prior to the prewar period and 44.5 per cent for its taxable year 1917 are more truly an indication of its earning power than can justly and equitably be arrived at by the use of the comparatives selected by the Unit.

Section 203 of the Revenue Act of 1917 provides:

That for the purposes of this title the deduction shall be as follows, except as otherwise in this title provided:

(a) In the case of a domestic corporation, the sum of (1) an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the prewar period was of the invested capital for the prewar period (but not less than seven or more than nine per centum of the invested capital for the taxable year). * * *.

Section 205 provides:

(a) That if the Secretary of the Treasury, upon complaint, finds * * * (2) that during the prewar period the percentage, which the net income was of the invested capital, was low as compared with the percentage, which the net income during such period of representative corporations, * * * engaged in a like or similar trade or business, was of their invested capital, then the deduction shall be the sum of (1) an amount equal to the same percentage of its invested capital for the taxable year which the average deduction (determined in the same manner as provided in section two hundred and three, without including the $3,000 or $6,000 therein referred to) for such year of representative corporations * * * engaged in a like or similar trade or business is of their average invested capital for such year plus (2) in the case of a domestic corporation $3,000 * * *.

In the enactment of these two sections of the law Congress assumed that the business of the three years immediately preceding the outbreak of the war on August 1, 1914, would, in general, afford a reliable measure of the average normal business of the corporation; but in the instant case, the application of section 203 appears to work an injustice because this period (referred to in the law as the "prewar period") was, for this taxpayer, rendered abnormal and not a true measure of its normal average business, by reason of the fact that it was in this very period that it undertook the development of its business of refining in addition to the business theretofore conducted by it.

For the alternative consideration of this case under section 205, the Committee requested the Unit to furnish statistics covering a broader field than that represented by the three comparatives previously used, in view of the taxpayer's protest that these are not truly representative for the reason that, so far as it knows, it is the only corporation of this character which engages in the purchase of raw material direct and disposes of such material after the portion used for the finished product has been separated therefrom.

From the statistics presented by the Unit in compliance with this request, and which include 249 corporations capitalized at from $10,000 to $10,000,000, it appears that 103 of them had prewar earnings of 7 per cent, and 124 had prewar earnings between 8.80 per cent and 8.99 per cent—the average for the entire 249 corporations being 8.1 per cent.

The Committee is of the opinion that, under the circumstances, this broader field presents a truer basis of comparison than do the three companies whose capital is in the class with that of the taxpayer but whose business, according to the taxpayer, is much more limited in its scope.

In consideration of these facts and of the fact of this company's high rate of earnings prior to the year 1911 when it began the installation and development of the new branch of its business and that in the prewar period its earnings, exclusive of the loss on its capital invested in its refinery business then being developed, were 11.1 per cent, and of the fact that in the taxable year 1917 itself this company's earnings were 44.5 per cent of its invested capital, the Committee is of the opinion that this taxpayer, for the year 1917, is entitled to further relief than that heretofore granted to it by the Income Tax Unit, and that its deduction under sections 203 and 205 of the Revenue Act of 1917 should be computed at 8.1 per cent of its invested capital.

SECTION 327, ARTICLE 901: Treatment of special cases. 20–20–945
A. R. R. 110

REVENUE ACT OF 1917.

Recommended in re appeal of N Company, that its application for assessment under the provisions of section 210 of the Revenue Act of 1917 be granted.

The Committee on Appeals and Review has had under consideration the appeal of the N Company from a decision of the Income Tax Unit denying its application for assessment under the provisions of section 210 of the Revenue Act of 1917 and assessing the

tax for that year under the provisions of sections 201 and 207 of the Act.

It appears that this corporation was organized in 1909, with an authorized capital stock of $10x$ dollars fully paid in, of which $4x$ dollars is represented by cash and $6x$ dollars is represented by working models turned in by A, president of the corporation, for which he received stock in that amount. The corporation since the date of its organization has been engaged in the manufacture of machinery, and on January 1, 1917, it had an accumulated surplus of $85x$ dollars and capital stock of $10x$ dollars or a total capital as shown on the return for 1917 of $95x$ dollars.

The corporation has concurred in all the adjustments made by the Income Tax Unit with the exception of two. It protests against the failure on the part of the Unit to allow the addition to invested capital of an item of $30x$ dollars originally claimed on account of the patents, good will, and other assets, partly tangible and partly intangible, which were put into the corporation by one of its officers and stockholders at the time of organization and also against the disallowance of $15x$ dollars as a deduction in computing net income for 1917 set up as a reserve for cost of construction, etc. This reserve was set up on the books of the corporation to take care of the expense of installing machinery sold during the year 1917, but which had not been installed at the close of the year. It subsequently developed that the amount actually paid out for installation in 1918 and charged to this reserve was $10x$ dollars. This amount has been allowed to the corporation in office letter dated March 1, 1920. In this letter the corporation's application for assessment under the provisions of section 209 was denied and it was notified that its correct tax liability for 1917 was $24x$ dollars.

It is urged that it would have been impossible for the present company to have succeeded on the small capitalization had it not been for the other property, both tangible and intangible, put into the business by A for which he received no stock. It is further urged that at the time the corporation was organized no consideration was given to the fact that the property turned in by A, including the patterns valued at $6x$ dollars had a value largely in excess of the par value of the stock issued to A for the patterns alone. In this way it is urged that the corporation is penalized through not having issued capital stock for the full valuation of both the tangibles and intangibles paid into the corporation by A.

The record further discloses that at the time of dissolution of the M Company, the patterns which were given to A by that company and later turned over by him to the N Company were carried on the books of the M Company at a valuation of $16x$ dollars, and that the patents were also carried on its books at a valuation of $45x$ dollars. No part of the good will or the patents is represented in the capitalization of the present company. This, it is urged, entitles the corporation to consideration under the provisions of section 210 of the Revenue Act of 1917.

The excess profits tax of this corporation has been determined under the provisions of sections 201 and 207 at 48.58 per cent of the net income. The corporation, through its accountants, contends that this is due to the conservative accounting and low capitalization at

the time of organization, and also to the fact that the corporation is denied in the computation of its invested capital amounts, such as patents, good will, etc., actually paid into the business and actually earning income for the corporation on which it is paying a tax.

The Committee has carefully considered the points at issue and the arguments made by the representatives of the corporation, and has reached the conclusion that this corporation has capital which is earning income but which can not be used in the computation of its invested capital for 1917 under the statutory provisions of section 207.

Article 52 of Regulations 41 provides among other things, that a claim for assessment under the provisions of section 210 may arise in cases where—

long-established business concerns, which by reason of ultra-conservative accounting or the *form* and *manner of their organization would*, through the operation of section 207, be placed at a serious disadvantage in competing with representative concerns in a like or similar trade or business.

In view of the foregoing the Committee feels that this corporation should be taxed under the provisions of section 210 and recommends that the decision of the Income Tax Unit be reversed for the reasons stated above.

SECTION 327, ARTICLE 901: Treatment of special cases. 20–20–946 T. D. 3017

In order to remove misapprehensions which have arisen as to the meaning of articles 14, 15, and 16, Regulations 41, these articles are hereby amended, in conformity with the construction uniformly placed thereon by the Commissioner of Internal Revenue, to read as follows:

ART. 14. *Classification of trades or businesses.*—For the purpose of the excess profits tax trades or businesses which are subject to the tax shall be divided into two classes, as follows:

A. Trades or businesses having no invested capital or not more than a nominal capital, including, in the case of *individuals*, occupations in which they receive salaries, wages, fees, or other compensations; and

B. Trades or businesses having more than a nominal capital.

In the case of a *corporation or partnership*, all the trades and businesses in which it is engaged shall be treated as a single trade or business (as provided in sec. 201), and all its income from whatever source derived shall be deemed to be received from such trade or business, and if in such trade or business, considered as a unit, such corporation or partnership employs more than a nominal capital (whether invested, borrowed, or of any other character), it will not be entitled to be assessed under the provisions of section 209.

Inasmuch as all the trades or businesses in which a corporation or partnership is engaged are treated as one, a corporation or a partnership shall be allowed either the deduction provided for in section 203 or the deduction provided for in section 209 (depending on the character of its trade or business), but not both.

In the case of *an individual* each trade or business in which he is engaged, the net income from which is subject to the excess profits tax, shall be classified as provided in this article. Each trade or business in class A shall be taxed as provided in article 15, and each trade or business in class B shall be taxed as provided in article 16. If an individual is engaged in two or more trades or businesses, in one of which he employs more than a nominal capital (whether invested, borrowed, or of any other character) he will be assessed under the provisions of section 209 only as to those trades or businesses in

which he employs no invested capital or not more than a nominal capital; and as to all others, he will be assessed under section 201.

If an individual has more than one business with invested capital, they will all be regarded as one, and (under the provisions of section 203) only one deduction will be allowed; if he has more than one business with not more than a nominal capital, they will be regarded as one, and (under the provisions of section 209) only one deduction will be allowed. If he has both kinds of businesses he will be regarded as having two businesses and there will be two deductions—but not more than two. (See articles 35 and 36, Regulations 41.)

Art. 15. *Rate of tax on trades or businesses in class A.*—The tax upon trades or businesses in class A as defined in article 14 shall be computed at the rate of 8 per cent upon the net income thereof in excess of $3,000 in the case of a *domestic corporation;* upon the net income thereof in excess of $6,000 in the case of a *domestic partnership* or of a *citizen* or *resident* of the United States; and upon the net income thereof without deduction in the case of a *foreign corporation or partnership* or of a *nonresident alien* individual.

Art. 16. *Rate of tax on trades or businesses in class B.*—The tax upon trades or businesses in class B, as defined in article 14 shall, except as otherwise provided in article 17, be computed at the following rates:

20 per cent of the amount of the net income in excess of the deduction (determined as provided in articles 21, 23, and 24) and not in excess of 15 per cent of the invested capital for the taxable year;

25 per cent of the amount of the net income in excess of 15 per cent and not in excess of 20 per cent of such capital;

35 per cent of the amount of the net income in excess of 20 per cent and not in excess of 25 per cent of such capital;

45 per cent of the amount of the net income in excess of 25 per cent and not in excess of 33 per cent of such capital;

60 per cent of the amount of the net income in excess of 33 per cent of such capital.

The illustration given in paragraph 28 of Regulations 41 remain without change.

SECTION 328.—COMPUTATION OF TAX IN SPECIAL CASES.

SECTION 328, ARTICLE 911: Computation of tax in special cases.

(See 5–20–723; sec. 337, art. 971.) Application of the provisions of this section in case of a corporation which is also entitled to the benefit of the provisions of section 337.

SECTION 328, ARTICLE 911: Computation of tax in special cases.

(See 11–20–788; sec. 326, art. 845.) Adjustment of invested capital for taxable year when claim for assessment of tax for previous year under section 328 remains unsettled.

SECTION 328, ARTICLE 913: Determination of first installment of tax in the case of foreign corporation. 6–20–735 O. D. 402

The installments of the tax for 1919 of a foreign corporation shall be determined upon the basis of an excess profits tax computed by using its invested capital for the taxable year 1917 properly adjusted

by reason of subsequent changes. Because of the provisions of section 302 this tax can in no case be more than 20 per cent of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per cent of the amount of net income in excess of $20,000. Final determination of the tax will be made according to the provisions of sections 327 and 328.

PART VI.—REORGANIZATIONS.

SECTION 330.—REORGANIZATIONS.

SECTION 330, ARTICLE 931: Scope of reorganizations. 22-20-981 Sol. Op. 4

WAR PROFITS AND EXCESS PROFITS TAX—REVENUE ACT OF 1918, INVESTED CAPITAL.

A merger of two or more corporations takes place when one of such corporations retains its corporate existence and absorbs the other or others, which thereby lose their corporate existence.

A consolidation of two or more corporations is effected when a new corporation is created to take the place of the constituent corporations, which are themselves dissolved in the process.

This case involves the formation in 1904 of the M Company through a so-called merger or consolidation of three New Jersey corporations: the N Company, the O Company, and the P Company, the latter of which owned a controlling proportion of the stock of the two other constituent corporations. The question upon which advice is desired in computing the invested capital of the M Company is whether it was formed as a new corporation in 1904 in connection with the dissolution of the three constituent corporations, or whether, as claimed by the company, it was the same corporate entity (only under a different name) as the P Company which by merger had absorbed the N and O Companies.

Strictly speaking, a merger of two or more corporations takes place when one of such corporations retains its corporate existence and absorbs the other or others, which thereby lose their corporate existence. A consolidation in a strict legal sense is effected when a new corporation is created to take the place of the constituent corporations, which are themselves dissolved in the process. *Lee* v. *Atlantic Coast Line Railway Co.*, 150 Fed. 775, 787.

The determination of whether a union of corporations results in a merger or in the formation of a new corporation depends upon the statute under which it takes place, and the intention therein manifested. *Central Railroad Co.* v. *Georgia*, 92 U. S. 665, 670.

The merger or consolidation, as the case may be, which is here under consideration was effected under a New Jersey statute entitled: "An Act concerning corporations (revision of 1896)" and the several supplements thereto and Acts amendatory thereof. The statute provides that two or more corporations organized under the laws of the State for the purpose of carrying on business of the same or a similar nature may "merge or consolidate into a single corporation, which may be either one of said merging or consolidating corpora-

tions, or a new corporation to be formed by means of such merger and consolidation."

The New Jersey law clearly authorizes either a process by which one corporation retains its corporate existence and absorbs one or more other corporations, or a process by which two or more corporations unite in the formation of a new corporation; but the interpretation of the various provisions of the statute is somewhat confused for the reason that the terms "merge" and "consolidate" in their different grammatical forms are employed therein more or less indiscriminately and without regard to the true legal niceties of their respective meanings.

The Act in reality gives an option to the constituent corporations to unite either by the merger of one or more into another or by the formation of a new corporation to take the place of the old ones. Difficulty arises in determining which of the two options is exercised in a particular instance since the statute prescribes substantially the same procedure in one case as in the other. The terms of the agreement entered into as a first step in the union of the corporations furnish the best evidence of what the parties intended in this respect.

In examining the language of the agreement entered into in 1904 between the respective directors of the N Company, the O Company, and the P Company, but little aid is obtained from a consideration of the use of the terms "merge" and "consolidate" for the reason that they are employed, as in the case of the New Jersey statute, in a confused and inexact sense. The true intention, therefore, must be ascertained by other tests.

It is claimed in behalf of the corporation that the N Company and the O Company were merged in the P Company, which retained its corporate existence under the name of the M Company. There is no evidence in the record other than the bare assertion to support that contention. If that had been the intention it is believed at least that in the resulting corporation some distinctive feature of the P Company would have been preserved by which its survivorship could be recognized. As the matter stands there is no basis other than conjecture or surmise to justify an inference that the P Company survived to any greater extent than the other two constituent companies, and it is conceded that the latter were dissolved.

It is true that the P Company by virtue of its stock holdings in the other companies was the parent corporation of the group and that its powers more nearly corresponded to the powers of the resulting M Company than to those of the other constituent corporations, but such facts merely create a likelihood that the P Company would have been the one elected to survive if any had been chosen; they do not show the fact of such election.

On the other hand, there are various provisions in the agreement which indicate that the resulting M Company was regarded as a separate corporate entity distinct from that of any of the three constituent companies, as evidenced by the following quotations:

Article V. The said corporations are merged and consolidated upon the understanding and agreement that the present indebtedness of each of said corporations shall be assumed in full by the said merged corporation.

Article VI. All property, real, personal, and mixed, of the said corporations, parties hereto, shall vest in the said merged corporation immediately upon the adoption of this agreement by the stockholders of the said corporation, as pro-

vided by the provisions of the said Act entitled "An Act Concerning Corporations (Revision in 1896)" and the several supplements thereto and Acts amendatory thereof; but if the said merged corporation shall deem or be advised that any further assignments, assurances in the law, or things are necessary or desirable to vest the title to such property in the said merged corporation, the said corporations, parties hereto, shall execute and do all such assignments, assurances in the law, and things necessary to vest title to such property in said merged corporation, and otherwise to carry out the purposes of this agreement.

Article VII (in part). The capital stock of each of the said corporations, parties hereto, shall be converted into the common stock, the preferred stock, or the obligations of said merged corporation, and the common stock, preferred stock, and obligations of said merged corporation shall be apportioned among the stockholders of the said corporations, parties hereto, according to the shares held by the respective stockholders of said corporations, and shall be delivered to them upon the surrender of their certificates of stock. * * * By the act of merger the stocks of all the companies, parties hereto, held by any of the companies, parties hereto, shall stand and be canceled.

The most important evidence as to the status of the M Company is found in article II of the agreement of 1904. As a first step in the union of corporations the New Jersey statute provides for an agreement between the directors, which must then be submitted to and ratified by a two-thirds vote of the stockholders of the respective corporations. Thereafter the perfected agreement is to be filed with the Secretary of State when the merger or consolidation becomes complete, and the resulting corporation becomes vested with all the powers, rights, privileges, and franchises of the constituent corporations. The statute also prescribes what must be embodied in the agreement, including the terms and conditions of the merger or consolidation, the mode of carrying the same into effect, and various other provisions, but does not require any statement therein of the powers of the resulting corporation. In article II of the directors' agreement in the case at hand it is expressly provided that the said merged corporation in addition to the powers conferred by section 1 of the "Act Concerning Corporations" (which section covers the usual powers of corporations) "shall have the powers herein set out." Then follows an elaborate enumeration.

It appears, therefore, that it was the intention of the agreement to vest the so-called "merged corporation" with a distinct and complete set of powers such as would be conferred upon a new corporation rather than to permit the statute itself to operate by conferring on it merely the resultant powers of the old corporations.

Thus the final result of the union of the N Company, the O Company, and the P Company was that each of said corporations alike was left without property and stock—the latter of which particularly, or its equivalent, is in some form essential to corporate existence, *Keokuk & Western Railroad* v. *Missouri*, 152 U. S., 301; 309—and there emerged in their place a corporation having new stock, new officers and directors, and a new, distinct, and complete grant of corporate powers.

In view of the foregoing considerations, particularly of the distinct corporate character designed for the resulting corporation as evidenced by the directors' agreement, and also the lack of evidence to manifest the intention of the parties that the P Company, or any of the other constituent corporations, should survive and absorb the others, it is my opinion that the M Company was created as a new

corporation in 1904 through the union of the N Company, the O Company, and the P Company.

WAYNE JOHNSON,
Solicitor of Internal Revenue.

SECTION 330, ARTICLE 931: Scope of reorganizations.

(See 25–20–1022; sec. 331, art. 941.) Valuation of assets transferred upon change of corporate entity.

SECTION 330, ARTICLE 933: Election to be taxed as corporation.

(See 15–20–854; sec. 252, art. 1034.) Adjustment of excess taxes paid in cases arising under paragraph 3, section 330, Revenue Act of 1918.

SECTION 330, ARTICLE 933: Election to be taxed as corporation. 16–20–872 O. 1023

INCOME TAX—SECTION 330, REVENUE ACT OF 1918.

Corporations de facto.

No taxpayer can be entitled to the benefits of the third paragraph of section 330 unless a corporation *de jure* or *de facto* came into existence prior to July 1, 1919.

The intention to incorporate, the execution and mailing of the articles of incorporation to the Secretary of State on June 30, 1919, the opening of corporate books as of June 30, 1919, and the manufacturing for one day under the same name as used by the partnership, in the absence of other proof of user prior to July 1, 1919, held not to justify the inference that a corporation *de facto* existed before July 1, 1919.

The M company was a partnership engaged in manufacturing during the calendar year 1918. Early in 1919 the advisability of incorporating and obtaining the benefits of section 330 of the Revenue Act of 1918 was considered and a determination to incorporate prior to July 1 was reached. So far as appears only the following events took place prior to July 1: The determination to incorporate was reached. The plant closed down on June 27, and an inventory was taken as of June 27. No business was transacted as a partnership after June 27. The plant reopened on June 30; and the accounts of the corporation began as of June 30. So far as appears the only work done on June 30 was manufacturing. Articles of incorporation were drafted, signed, and acknowledged, and mailed to the Secretary of State on June 30. Minutes of the first meeting and by-laws were drafted by counsel, and it was decided who the temporary dummy directors should be.

No other evidence tending to show user of corporate powers prior to July 1 was in evidence, although the parties made every effort to produce all facts in their favor.

Because of defects in the articles, they were returned by the Secretary of State, amended, and actually filed on July 2, 1919. It was stated orally that the first meeting was held, directors were elected, and the property was formally transferred from the partnership to the corporation after July 2. It is the contention of the company that it became a *de facto* corporation on June 30, 1919. Section 330, of the Revenue Act of 1918, reads in part as follows:

> 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 has been in existence on and after January 1, 1918, and the undistributed profits or earnings of such trade or business shall not be subject to the surtax imposed in section 211, but amounts distributed on or after January 1, 1918, from the earnings of such trade or business shall be taxed to the recipients as dividends, and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade or business: *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: *Provided further*, That any taxpayer who takes advantage of this paragraph shall pay the tax imposed by section 1000 of this Act and by the first subdivision of section 407 of the Revenue Act of 1916, as if such taxpayer had been a corporation on and after January 1, 1918, with a capital stock having no par value.

This is a remedial provision and should be liberally construed. It will be assumed that in this controversy the Government stands in the same position as an ordinary creditor, and that it is sufficient if the existence of a *de facto* corporation is shown.

The requisites of a *de facto* corporation are, first, the existence of a charter or law under which a corporation with the powers assumed might lawfully exist; second, an effort in good faith to incorporate thereunder; and, third, an actual user or exercise of corporate powers. *Tulare Irrigating District* v. *Sheppard*, 185 U. S. 1.

In applying these tests, however, there is considerable conflict in the decisions even from the same jurisdiction. It may be admitted that the first two requisites were complied with in this case on June 30; but there is great doubt whether there was a sufficient user or exercise of corporate powers prior to July 1, 1919, to justify a decision that a *de facto* corporation existed. Only one day's user of corporate powers is claimed, and so far as appears no business of a peculiarly corporate nature was transacted on that day.

> It is essential to the existence of such a corporation (a *de facto* corporation) that there be user of such corporate rights as could be authorized by law and not merely such as might be exercised by individuals or unincorporated societies. If such a user, therefore, consists only of acts or proceedings that might be exercised without incorporation, a corporation *de facto* will not usually be inferred therefrom. (Citing cases.) Under the allegations of the bill the name "Elgin Jewelry Company" was so used by defendants under which to conduct their business before any attempt at incorporation, and the use of such name is entirely consistent with individual or copartnership capacity.—*Elgin National Watch Company* v. *Loveland*, 132 Fed. 41, 45, 1904.

Merely manufacturing under the name of M Company is, therefore, not a sufficient user of corporate powers, since they were merely doing what had been done for a long period under the same name by the copartnership. In fact it affirmatively appears that the acts, which

are usually the first acts, such as first meeting, adoption of by-laws, and election of officers, took place after July 1.

A recent authority, discussing the question of user in this connection, says:

> Generally, it is sufficient to show that the corporation was acting as a corporation and transacted business as such. But there is no fixed rule for determining just how much business must be done. Taking subscriptions to and issuing stock, electing managers and directors, adopting by-laws, buying a lot and constructing and leasing a building upon it; electing officers and trustees, who manage the corporate property for years, and lease and mortgage it, and expend large sums of money, executing powers of attorney, and loaning money and taking a loan and mortgage therefor, have been held to be sufficient. (Fletcher, Cyclopedia of Corporations, Vol. I, p. 625.)

It is significant that the illustrations given all include action of a peculiarly corporate nature and all include acts which are not present in the case under consideration.

It is clear that mere execution of the articles of incorporation is not a sufficient basis for inferring the existence of a corporation *de facto*. *Stevens* v. *Episcopal Church History Co.*, 125 N. Y. Supp. 573. The mailing of such articles to the Secretary of State may indicate an attempt in good faith to comply with the statutory requirements but can not be said to be a user of corporate powers. (Fletcher, Cyclopedia of Corporations, Vol. I, p. 625.)

In the case of *Childs* v. *Smith*, 45 N. Y. 34, principally relied upon by the taxpayer, meetings were held, officers were elected, by-laws adopted, minutes kept, and business done. These were peculiarly corporate acts and indicated a state of facts very different from the one now in question. (So in re Cordova Shop, 216 Fed. 818.)

No case has been found which would justify a decision that there was a sufficient user of corporate powers prior to July 1, 1919, in this case from which to infer the existence of a corporation *de facto*. Under these circumstances administrative officers are not justified in extending the definition of *de facto* corporation beyond the limits established by the courts. Nor can the administrative officers extend the time limit established by Congress in section 330.

Some reliance is placed by the taxpayer upon the language of section 330 which requires the "organization as a corporation before July 1, 1919, of any trade or business." Under any interpretation of these words, however, it seems clear that a corporation *de jure* or *de facto* must exist prior to July 1. No such corporation existed at that time in this case, and the taxpayer must therefore be denied the benefits of section 330.

SECTION 331.—VALUATION OF ASSETS UPON REORGANIZATION.

SECTION 331, ARTICLE 941: Valuation of asset upon change of ownership. (Also Section 239, Article 621.) — 3-20-697, A. R. R. 16

> Mere change of domicile without change as to capital and surplus held not to affect the invested capital, which remains the same for the new company as for the old.

The facts in the case appear to be that the M Company, a corporation organized in a certain State, decided that its development

would be hampered by its organization in that State and it was therefore decided to reincorporate the company in another State. Accordingly, a new corporation was formed in another State which exchanged its stock directly with the stockholders of the old corporation for their stock, share for share. No change was made in the capitalization or the surplus, but after it had acquired all of the stock of the old corporation the assets of the old corporation were transferred to the new corporation and the charter of the old corporation surrendered. This was in essence merely a reincorporation in a different State without essential change as to business, capitalization, or surplus.

The change of domicile took place in 1916, and the Committee has considered a number of precedents established under the Acts of 1913 and 1916 with regard to the treatment of essentially similar transactions. It finds that under such conditions it was the practice of the Bureau to require only one return as covering the income of both the old and the new corporation. It also finds that in numerous cases it was held that no income accrued to the stockholders by reason of exchange of their stock in the old for stock in the new corporation.

The Committee is of the opinion that it is not necessary to make any radical departure from the "distinct entity" theory which has been the guide of the Bureau in the past, but feels that where there is merely a transfer of domicile through the surrender of the charter issued in one State and the taking out of a new charter in another State, without any change in the business or amount of the capital and surplus of the corporation, that the new company is entitled to the same invested capital as the old.

It is therefore recommended that the M Company (new) be permitted to use the invested capital which would have been permitted the M Company (old) if there had been no surrender of charter, and change of domicile.

SECTION 331, ARTICLE 941: Valuation of asset upon change of ownership. 15–20–855 O. D. 458
(Also Section 214(a) 8, Article 161.)
(Also Section 214(a) 10, Article 201.)

The provisions of section 331 of the Revenue Act of 1918 relate only to the computation of invested capital. In the reorganization of a corporation owning timber lands and engaging in the manufacture of lumber, the basis for deductions for depletion of the timber and depreciation of the plant, machinery and patents claimed by the reorganized company is the cost of these assets at the time they were acquired in reorganization, or their fair market value as of March 1, 1913, if acquired prior thereto.

SECTION 331, ARTICLE 941: Valuation of asset upon change of ownership. 25–20–1022 A. R. M. 60
(Also Section 330, Article 931.)

REVENUE ACT OF 1917.

The question is submitted whether or not where there was a change of corporate entity prior to March 3, 1917, without a change

of officers or directors, or proportions of stockholdings, the new corporation is limited in its invested capital to that which might be claimed by the old corporation, or whether, in such case, the new corporation is entitled to recognize the cash value of assets for which its stock was issued not in excess of the par value thereof.

The point is illustrated by the cases of two corporations, each of which was reorganized in 1916 and the larger amount of stock issued against appreciated value, patents, good will, etc.

Section 207 of the Revenue Act of 1917 provides for the recognition as invested capital of—

(1) actual cash paid in; (2) 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 * * *, etc.

It is clear that this means subject only to the limitation in the section itself and in section 208, the actual cash paid in or the actual value of tangible assets paid in to the specific corporation, which is the present taxpayer. The limitation in section 208 referred to is:

That in case of the reorganization, consolidation, or change of ownership of a trade or business after March third, nineteen hundred and seventeen, if an interest or control in such trade or business of fifty 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, 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.

The necessary corollary of the provision quoted above is that if the reorganization, consolidation, or change of ownership took place prior to March 3, 1917, the actual value of the assets paid in, limited by the provisions of section 207, is the invested capital.

The only question, therefore, left in the case is: Was there such a change of entity in the corporations named as to create in effect a new corporation? The uniform practice for some years in dealing with the question of sales of stock has been to treat every change of corporate entity as the creation of a new organization. The only exception to this has been in the case of a mere change of domicile; that is to say, surrender of charter in one State and the taking out of a new charter in a different State, without change, however, in the amount of the stock, the identity of the stockholders or capital and surplus as it appears on the books of the corporation.

It is clear that under the rulings of the office stockholders who in either of the cases above mentioned, surrendered their stock, receiving therefor stock in the new corporation, would have been held liable to income tax if the value of the stock received was in excess of the cost of the stock surrendered therefor, or the value of such surrendered stock on March 1, 1913, on the ground that there had been an exchange of property of one kind for property of a different kind.

The Committee is therefore clearly of the opinion that both of the corporations in question are entitled to the actual cash value of the tangible and intangible properties paid in for their stock in 1916, subject only to the limitations provided in section 207 as to the value of the intangibles which may be recognized.

PART VII.—MISCELLANEOUS.

SECTION 335.—FISCAL YEARS ENDING IN 1918 OR 1919.

SECTION 335, ARTICLE 951: Fiscal year with different rates. 8-20-760 A. R. R. 26
(Also Section 218, Article 321.)

RULING UNDER REVENUE ACT OF 1917.

Held, that a partnership which had consistently closed its books on a day other than the end of a calendar month is entitled, notwithstanding, to a pro rata basis in determining income of the fiscal year ending in 1917 subject to excess profits tax.

The Committee is in receipt of the appeal of A and B, a partnership, from the ruling of the Income Tax Unit holding them liable for excess profits tax on the specific earnings from January 1, 1917, to April 15, 1917, instead of on the proportionate part of their fiscal year falling within the calendar year 1917.

The facts in the case appear to be that A and B was a partnership which had a fiscal year ending April 15, and that on April 15, 1917, the then existing partnership was dissolved and a new partnership was formed which continued the business. The ruling of the Income Tax Unit is evidently based upon the provisions of the regulations and the law of 1918, neither of which recognizes as a fiscal year an accounting period ending on any other day than the last day of the month.

Fiscal years, other than calendar years, as accounting periods were first recognized under the law of 1913 which provided (section G (c)) that corporations might designate "the last day of any month in the year as the day of the closing of its fiscal year," but this provision did not extend to partnerships, nor was it in the form of a definition of the term "fiscal year." Regulations 33, however, promulgated under that Act, which authorized corporations to make return on the basis of an established fiscal year, provided that changes from calendar year basis to fiscal year basis would be recognized, provided the last day of the month selected as the closing month of the fiscal year was designated as the close of the fiscal year. Partnerships were not required under this Act to make return, neither were they required to make return under the Revenue Act of 1916; and not until the passage of the Revenue Act of 1917, some months after the dissolution of this partnership, was a return required of a partnership except upon specific demand therefor by the Commissioner. The Revenue Act of 1917, in imposing an excess profits tax on partnerships as well as corporations for the year 1917, provided that if such corporation or partnership made a return covering its own fiscal year and included therein the income received during that part of the fiscal year falling within the calendar year for 1916 "the tax for such taxable year shall be that proportion of the tax computed upon the net income during such full fiscal year which the time from January first, nineteen hundred and seventeen, to the end of such fiscal year bears to the full fiscal year." Again no specific provision of law was made defining fiscal year as being a year ending on the last day of a month other than December 31.

It was apparently the consistent practice of this partnership to close its books in the past on April 15, and in doing so it established so far as it might, a fiscal period ending April 15. The Committee is, therefore, of the opinion that the subsequent provision in the regulations under the Revenue Act of 1917, providing that the fiscal year of a partnership should end on the last day of a month, is not to be regarded as effective against a fiscal year ending on some day other than the close of a month in 1917 prior to the passage of the law and the promulgation of the regulations.

It follows, therefore, that the contention of A and B is well taker and the Committee recommends that the tax be recomputed and the excess profits tax levied upon 3½ twelfths of their income for the entire fiscal year ended April 15, 1917, instead of upon the specific period from January 1, 1917, to April 15, 1917.

SECTION 337.—SALE OF MINERAL DEPOSITS.

SECTION 337, ARTICLE 971: Tax on sale of mineral deposits. 5–20–723 O. D. 395

(Also Section 328, Article 911.)

The fact that a company is entitled to the benefit of section 337 will not disqualify it for special treatment under section 328, neither can the fact that it is entitled to the benefit of section 337 be used as a basis for claiming special treatment under section 328. If a corporation falls within the class specified in section 327, the tax will be determined under the provisions of section 328. The effect of section 337 is to limit the amount of tax attributable to the profit made on the sale of mines, oil and gas wells discovered by the taxpayer and can only be applied after the tax computed on such profit has been computed without the benefit of this section.

Title XIII.—GENERAL ADMINISTRATIVE PROVISIONS.

SECTION 1314.—MEDIUM OF PAYMENT OF TAX.

SECTION 1314, ARTICLE 1731: Payment of tax by certificates of indebtedness. 7-20-748 T. D. 2973

Collectors of internal revenue are authorized and directed to receive at par United States Treasury certificates of indebtedness of Series T 8, dated July 15, 1919, Series T 9, dated September 15, 1919, Series T M 3–1920, dated December 1, 1919, and Series T M 4–1920, dated February 2, 1920, all maturing March 15, 1920, in payment of income and profits taxes payable on March 15, 1920. Collectors are authorized and directed to receive at par Treasury certificates of indebtedness of Series T J 1920, dated December 15, 1919, maturing June 15, 1920, in payment of income and profits taxes payable on June 15, 1920; Treasury certificates of indebtedness of Series T 10, dated September 15, 1919, maturing September 15, 1920, in payment of income and profits taxes payable on September 15, 1920; and Treasury certificates of indebtedness of Series T D 1920, dated January 2, 1920, maturing December 15, 1920, in payment of income and profits taxes payable on December 15, 1920. Collectors are further authorized and directed to receive at par, in payment of income and profits taxes payable at the maturity of the certificates, respectively, Treasury certificates of indebtedness of any series maturing on March 15, June 15, September 15, or December 15, 1920, respectively, and expressed to be acceptable in payment of income and profits taxes. Collectors are not authorized hereunder to receive in payment of income or profits taxes any Treasury certificates of indebtedness not expressed to be acceptable in payment of income and profits taxes, or maturing on a date other than the date on which the taxes are payable. Collectors are authorized to receive Treasury certificates of indebtedness which are acceptable as above provided in payment of income and profits taxes, in advance of the respective dates on which the certificates mature. Treasury certificates acceptable in payment of income and profits taxes have one or more interest coupons attached, including as to each series a coupon payable at the maturity of the certificates, but all interest coupons must in each case be detached by the taxpayer and collected in ordinary course when due. The amount, at par, of the Treasury certificates of indebtedness presented by any taxpayer in payment of income and profits taxes must not exceed the amount of the taxes to be paid by him, and collectors shall in no case pay interest on the certificates or accept them for an amount other or greater than their face value.

Deposits of Treasury certificates of indebtedness received in payment of income and profits taxes must be made by collectors, unless otherwise specifically instructed by the Secretary of the Treasury, with the Federal reserve bank of the district in which the collector's head office is located, or in case such head office is located in the same

city with a branch Federal reserve bank, with such branch Federal reserve bank. Specific instructions may be given in certain instances for the deposit of the certificates with Federal reserve banks of other districts and branch Federal reserve banks. The term "Federal reserve bank," where it appears herein, unless otherwise indicated by the context, includes branch Federal reserve banks. Treasury certificates accepted by the collector prior to the dates when the certificates respectively mature should be forwarded by the collector to the Federal reserve bank to be held for account of the collector until the date of maturity and for deposit on such date.

Collectors of internal revenue are not authorized, unless otherwise notified by the Secretary of the Treasury, to receive in payment of income or profits taxes interim receipts issued by Federal reserve banks in lieu of definitive certificates of the series herein described.

Certificates of indebtedness should in all cases be stamped as follows by the collector and when so stamped forwarded to the Federal reserve bank by registered mail, uninsured:

_____, 192__

This certificate has been accepted in payment of income and profits taxes and will not be redeemed by the United States except for credit of the undersigned.

_____

Collector of Internal Revenue for the _____ District of _____

Collectors should make in tabulated form a schedule in duplicate of the certificates of indebtedness to be forwarded to the Federal reserve bank, showing the serial number of each certificate, the date of issue and maturity, and face value. Certificates of indebtedness accepted prior to the date of maturity must be scheduled separately. At the bottom of each schedule there should be written or stamped "Income and profits taxes, $_____," which amount must agree with the total shown on the schedule. One copy of this schedule must accompany certificates sent to the Federal reserve bank, and the other be retained by the collector. The income and profits tax deposits resulting from the deposits of such certificates must in all cases be shown on the face of the certificate of deposit (National Bank Form 15) separate and distinct from the item of miscellaneous internal revenue collections (formerly called ordinary), but it is not necessary to give the separation into corporation income, individual income, and profits taxes.

Until certificates of deposit are received from the Federal reserve banks the amounts represented by the certificates of indebtedness forwarded must be carried by collectors as cash on hand and not credited as collections, as the dates of certificates of deposit determine the dates of collections.

For the purpose of saving taxpayers the expense of transmitting such certificates as are held in Federal reserve cities or Federal reserve branch bank cities to the office of the collector in whose district the taxes are payable, taxpayers desiring to pay income and profits taxes by Treasury certificates of indebtedness acceptable in payment of such taxes should communicate with the collector of the district in which the taxes are payable and request from him authority to deposit such certificates with the Federal reserve bank or branch

in the city in which the certificates are held. Collectors are authorized to permit deposits of Treasury certificates of indebtedness in any Federal reserve bank or branch with the distinct understanding that the Federal reserve bank or branch is to issue a certificate of deposit in the collector's name covering the amount of the certificates of indebtedness at par and to state on the face of the certificate of deposit that the amount represented thereby is in payment of income and profits taxes. The Federal reserve bank or branch should forward the original certificate of deposit to the Treasurer of the United States, with its daily transcript, and transmit to the collector the duplicate and triplicate, accompanied by a statement giving the name of the taxpayer for whom the payment is made in order that the collector may make the necessary record and forward the duplicate to the office of the Commissioner of Internal Revenue.

This Treasury Decision amends and supplements the provisions of articles 1731 and 1732 of Regulations 45 and supersedes Treasury Decisions 2907 and 2918.

MISCELLANEOUS.

8-20-761
O. 999

MUNITION MANUFACTURER'S TAX—TITLE III, SECTION 301, REVENUE ACT OF 1916.

(1) Section 301, Revenue Act of 1916, taxes the profits received by every manufacturer from the sale or other disposition of the articles therein specified, whether he has contributed in whole or in part to their manufacture, provided the articles were manufactured and disposed of for the purpose of being used as munitions or as parts of the same.

(2) The words "any part" as used in section 301, Revenue Act of 1916, refer to "any part" of the process of manufacturing any of the articles therein specified for use as munitions.

(3) The tax provided for in section 301, Revenue Act of 1916, is only due when the articles were manufactured and disposed of for the purpose of being used as munitions or as parts thereof.

(4) The tax provided for by section 301, Revenue Act of 1916, is due regardless of whether the manufactured article has reached the state of completion when disposed of by the manufacturer.

(5) Law Opinions 238(a) and 91 and Solicitor's Memoranda 625 and 45 are overruled.

An opinion is requested as to what manufacturers are liable to tax under the provisions of section 301, Revenue Act of 1916.

Section 301, Revenue Act of 1916, is in part as follows:

(1) That every person manufacturing (*a*) gunpowder and other explosives, excepting blasting powder and dynamite used for industrial purposes; (*b*) cartridges, loaded and unloaded, caps for primers, exclusive of those used for industrial purposes; (*c*) projectiles, shells, or torpedoes of any kind, including shrapnel, loaded or unloaded, or fuses, or complete rounds of ammunition; (*d*) firearms of any kind and appendages, including small arms, cannon, machine guns, rifles, and bayonets; (*e*) electric motor boats, submarine or submersible vessels or boats; or (*f*) any part of any of the articles mentioned in (*b*), (*c*), (*d*), or (*e*), shall pay for each taxable year, in addition to the income tax imposed by Title I, an excise tax of twelve and one-half per centum upon the entire net profits actually received or accrued for said year from the sale or disposition of such articles manufactured within the United States; * * *

(2) This section shall cease to be of effect at the end of one year after the termination of the present European war, which shall be evidenced by the proclamation of the President of the United States declaring such war to have ended.

Some uncertainty has heretofore existed as to whether or not a manufacturer who performs part of the work of manufacturing an article specified in section 301 above quoted, but who does not complete the manufacture, either of the article or any part thereof, is liable to tax under this section on the profits which he receives from the sale of such article. It is for the purpose of clearing up this uncertainty that this opinion is prepared.

The munitions manufacturer's tax is an excise tax on the net proceeds received by every person manufacturing certain specified classes of munitions or any part of such munitions. The net proceeds subject to tax are those received or accrued from the sale or disposition of such articles manufactured within the United States.

In the year 1916 many manufacturers in the United States were making abnormal profits through the manufacture and sale of munitions to the allied Governments. The object of the munition manufacturer's tax was to reach, for taxation purpose, a greater percentage of these profits than was reached by the income tax.

The manufacture of munitions involves the manufacture of numerous component parts and the assembling of these parts. Each part in turn must pass through various processes in the course of its manufacture. In the year 1916 few, if any, manufacturers of munitions possessed the raw materials or facilities for manufacturing all of the component parts or for performing all of the processes essential to the manufacture of any particular part. As a result, when a principal manufacturer had contracted to supply certain munitions he frequently contracted with other submanufacturers for certain of the component parts of the munitions. In some cases these parts were furnished to the principal manufacturer completed and ready for assembling. In other cases they were delivered in a semicompleted condition, the remaining processes of manufacture being performed by the principal manufacturer. Likewise, many of the submanufacturers had recourse to still other manufacturers for supplying to them in semicompleted condition certain parts of munitions, which they in turn completed and passed on to the principal manufacturers for assembling. Thus it will be seen that the work of manufacturing munitions frequently involved the labor and materials of numerous submanufacturers, each of whom contributed in part to the manufacture of the completed article.

The selling price of the completed article necessarily included the profits received by the various manufacturers who had supplied the materials and labor essential to its completion. Where all the labor and raw materials were supplied by the principal manufacturer, he would receive the entire profit and the tax would fall upon him alone. On the other hand, where the labor and materials were supplied in part by submanufacturers, the tax was intended to fall on the profits of each such manufacturer. It was not the intent of the Act to impose a greater burden upon the principal manufacturer who had the raw materials and facilities for manufacturing all or practically all the component parts of a certain munition than upon other manufac-

turers who, by their combined labor and materials, produced a like article. The tax was intended to fall upon the profits derived by each manufacturer who, with knowledge of the use to which the completed article was to be put, contributed in whole or in part toward its manufacture. This is substantially the interpretation adopted by the United States Circuit Court of Appeals for the Third Circuit in the cases of *Carbon Steel Company* v. *Lewellyn, Collector; Worth Brothers Company* v. *Lederer, Collector;* and *Lewellyn, Collector*, v. *Forged Steel Wheel Company*, published in T. D. 2875, June 26, 1919.

Certain previous law opinions and Solicitor's memoranda of this Department have taken the view that in the manufacture of a munition, specified in section 301, Revenue Act of 1916, where the process of manufacture has not reached a stage in which the material involved was no longer serviceable for general commercial uses, no tax was collectible upon the profits of the manufacturer (see Law Opinion 238(*a*), Solicitor's Memoranda 625 and 45). These opinions proceed upon the assumption that the material to be used in a munition does not become a "part" of the munition, within the meaning of section 301, Revenue Act of 1916, so long as it remains an article adapted to ordinary commercial uses. Only when its manufacture has progressed to the stage where it is no longer serviceable, except as a munition, does it become a "part" of a munition (Regulations 39, art. 13).

In view of the opinion of the United States Circuit Court of Appeals, above referred to (T. D. 2875), the holdings of the opinions above mentioned must now be modified. The test is not whether the manufactured material used in a munition might have been sold as a commercial commodity, but simply whether it was in fact manufactured and disposed of for the purpose of being used as a munition. The intent of the manufacturer must be determined in each instance. Thus, if an article was manufactured for commercial purposes but was disposed of for the purpose of being used in making munitions, the manufacturer would not be liable to tax on the profits which he received from its sale. Nor would the tax be due, where the article, although manufactured for the purpose of being used for munitions, was in fact disposed of by the manufacturer for commercial purposes.

It is immaterial that the process of manufacture has not reached the stage of completion when the article is disposed of. The words "any part" as used in section 301, do not mean "any completed part," but refer to "any part" of the process of manufacture of an article for use as a munition or as a part thereof. Law Opinion 91 must be overruled, and it is suggested that Regulations 39, article 13, be modified in this particular.

It is, therefore, held that:

(1) Section 301, Revenue Act of 1916, taxes the profits received by every manufacturer from the sale or other disposition of the articles therein specified, whether he has contributed in whole or in part to their manufacture, provided the articles were manufactured and disposed of for the purpose of being used as munitions or as parts of the same.

(2) The words "any part" as used in section 301, Revenue Act of 1916, refer to "any part" of the process of manufacturing any of the articles therein specified for use as munitions.

(3) The tax provided for in section 301, Revenue Act of 1916, is only due when the articles were manufactured and disposed of for the purpose of being used as munitions or as part thereof.

(4) The tax provided for by section 301, Revenue Act of 1916, is due regardless of whether the manufactured article has reached the state of completion when disposed of by the manufacturer.

(5) Law Opinions 238(a) and 91, and Solicitor's Memoranda 625 and 45 are overruled.

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