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## Income-tax Department

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## Income-tax Department

EDITED BY STEPHEN G. RUSK

"Profit from the sale of municipal bonds is exempt from income tax, such tax being either on the bonds themselves or on the income arising therefrom," is the language used by Judge Cant of the United States district court, district of Minnesota, third division, in the case of *Bunn v. Willcuts, collector*.

This decision must be good news to a large body of taxpayers who have been under the impression that only interest derived from the obligations of a state, territory or any political subdivision thereof, or the District of Columbia, is excludible from gross income for federal income-tax purposes. To the writer, also, is it news, and he remembers with chagrin that he has advised his clients on numerous occasions that whereas interest on such obligations need not be included in gross income, any loss sustained or any profit earned on the sale or other disposition of such securities was properly includible in the elements comprising taxable income.

The judge's opinion sounds reasonable enough when he states that a tax on a profit from the sale is exempt from taxation, such tax being either on the bonds or on the income derived therefrom, but if he is right, it seems a bit strange that congress permitted the exclusion from gross income of only the interest on such securities.

Furthermore, the question immediately arises as to whether or not those financial houses the major part of whose income is derived from the purchase and sale of state, county, municipal bonds, etc., should have paid income taxes on the profits so earned.

A brief statement of the court's opinion is ventured in the following paragraphs:

1. The means and instrumentalities of a state government are exempt from taxation.
2. This principle is not based upon any constitutional provision. It rests on necessary implication.
3. It also covers income arising from such obligations.

(Conclusion):

It is, therefore, beyond dispute that income from bonds such as those here in question is not subject to a tax under the revenue law.

Further along, the court states it to be an underlying principle that the government shall not exercise the power of taxation in such manner as in any substantial degree to interfere with the state in any of its governmental functions.

The court is of the opinion that should the investing public know that any gain or profit realized from a rise in value of such bonds would be subject to a federal tax, this would operate to discourage the public from dealing in such securities and would cause a reduction in the prices which persons would be willing to pay therefor.

Even though one might prefer to believe with the court that a profit from the sale of such securities should be excludible from the gross income and, therefore, not subject to a tax, the fact that there is a marked difference between income

arising from the possession of such securities and that derived from buying and selling such securities causes some doubts to linger in one's mind. Furthermore, it seems doubtful if the taxing of income derived from the sale of such securities "in any substantial degree interferes with the state in its governmental functions."

Final decision of this case will be awaited with much interest.

A belated decision with respect to invested capital reduction, under the 1918 act, by reason of a tentative tax computed on the income for that year in determining the amount of current earnings available for payment of dividends, was rendered by the United States circuit court of appeals for the third circuit. This decision, if it had been rendered in any year between 1918 and 1924, would have saved taxpayers in those years some taxes. The Pittsburgh Knife and Forge Company, in whose case the decision was recently made, evidently did not agree with the commissioner's theory upon the subject, and was persistent enough to contend through years of litigation for that which it deemed to be proper.

Tax practitioners are familiar with the theory underlying this decision, wherein it was held by the commissioner that unless current earnings of a corporation were sufficient to cover a dividend paid during the year, invested capital must be reduced by the amount by which the dividend exceeded current earnings up to the date the dividend was paid. In arriving at current earnings, the commissioner insisted that the income tax on current earnings should be deemed to reduce the earnings available for dividend purposes. Most of the tax practitioners argued at the time that the income tax was not a liability of the current year, and, therefore, it should not be applied as a reduction of corporate net earnings of the current year. At last, these practitioners are justified, but to many of them there is little satisfaction in being proved correct at this late date.

#### RECENT RULINGS

The beverage tax imposed upon a manufacturer of soft drinks which had notified its customers that the price included the amount of tax imposed by sec. 628 of the act of 1918, should be computed on the full price received where he failed to bill the tax separately as required by the regulations. (Supreme court of the U. S. *Lash's Products Company v. United States*.)

Profit derived in 1917 and 1918 by a lessor of mining properties is the fair cash value on March 1, 1913, of the tonnage mined in such years, less the interest carrying charge of 5% from March 1, 1913, to the taxable years. (U. S. circuit court of appeals, seventh circuit, *Mabel G. Reinecke v. Collector*.)

The date of allowance of a credit is the date when the commissioner signed the "Schedule of overassessments and allowance of abatements, credits," etc., for transmission to the collector containing his authorization to apply overpayments of tax as a credit against taxes due, if any, and, where such allowance was made prior to the effective date of the 1926 act, the taxpayer is entitled to interest upon overpayments for the fiscal year 1918 from the date of such overpayment until the date of an additional assessment for the fiscal year 1919, against which such overpayment was credited, under sec. 1019 of the 1924 act. (District court of the U. S., western district of Pennsylvania. *Penn Smokeless Coal Co. v. United States*.)

Six corporations were held to be affiliated for 1920 where 71% of three corporations, 78% of a fourth and over 95% of a fifth were owned by the sixth corporation or its organization, which controlled other stock through agreements that the stock of the minority stockholders was to be offered for sale to the parent company first, and through proxies, and the companies were

guided by a common interest and a common object obtained by pursuing the same methods through the same agencies. (U. S. circuit court of appeals, seventh circuit, *The Great Lakes Hotel Co. v. Commissioner.*)

Profit from the sale of municipal bonds is exempt from income tax, such tax being either on the bonds themselves or on the income arising therefrom. (U. S. district court, third division of Minnesota, *Chas. Bunn v. Collector.*)

Profit from the sale in United States of goods manufactured abroad by a foreign corporation is gross income from sources within the United States within the meaning of sec. 233(b), act of 1918. (U. S. circuit court of appeals, second circuit, *Tootal Broadhurst Lee Company, Ltd., v. Commissioner.*)

Amount designated "bankers' commissions" paid in 1918 was held to be the purchase price of stock representing ownership in a fumigating plant and not a deductible expenditure in the nature of interest. Such amount was paid under an arrangement between the taxpayer and certain bankers by which the latter agreed to furnish the funds for the construction of such plant in consideration of the repayment of their advances plus a lump sum to be paid out of the earnings of the plant, which arrangement was carried out by the organization of a new corporation to which the bankers transferred the plant for stock plus cash equal to the organization shares and an agreement to repay the amounts expended for the plant, and the transfer of the stock of the new corporation to the taxpayer for the lump sum which was paid out of dividends of the new corporation. (District court of the U. S., district of Massachusetts, *Wiggin Terminals, Inc., v. United States.*)

Appeal from an order of the supreme court of the District of Columbia granting a temporary injunction restraining the collection of a tax barred by the statute of limitations was dismissed as premature, without passing on the merits of the case, such interlocutory injunction not being appealable, under the law, since it did not affirmatively change nor affect the possession of property. (Court of appeals, District of Columbia, *Andrew W. Mellon, sec'y. of treasury, v. Edward P. Mertz.*)

Amount paid by a lessee out of royalties accruing after a specified date from an undivided interest in an oil well under a compromise agreement between such lessor and another claiming title to the land adversely to that of the lessor's grantor providing for the payment to the adverse claimant of a stated amount out of the royalties to be received and the relinquishment by the party claiming title to the land of his adverse claim to such lessor's right to receive royalties, is not part of the lessor's gross income, since the ownership thereof vested in another when they accrued. (U. S. circuit court of appeals, fifth circuit, *United States v. Frank J. and Mrs. Frank J. Looney.*)

Sec. 611, act of 1928, is no defense to the collector in a personal action against him for the recovery of 1918 taxes collected June 7, 1926, under duress after the expiration of the statutory period on collection and when the liability therefor had been extinguished where a claim for abatement had been filed and rejected October 6, 1921, and the commissioner had thereafter granted special assessment, such section not being a specific retroactive ratification of an illegal collection by the collector as agent. (District court of the U. S., western district of Pennsylvania, *Clinton Iron & Steel Co. v. D. B. Heiner, collector.*)

Dividends received in 1917 by the executors of an estate on stock specifically bequeathed before such legacies were paid are income received by an estate during administration taxable as an entity to the estate under sec. 2(b), act of 1916, as amended, at the 1917 rates. (U. S. circuit court of appeals, first circuit, *Clarence M. Woolley, et al., executors, v. John F. Malley, former collector.*)

Income received by the executors of an estate in 1917 from the residuary estate the income of which was to be distributed to certain beneficiaries, before it had been transferred to trustees for beneficiaries as provided by the will, is assessable to the executors as income received during the period of administration of the estate, at the rates imposed upon executors as taxable persons under sec. 8(c), act of 1916 as amended. (U. S. circuit court of appeals, first circuit, *John F. Malley, former collector, v. Clarence M. Woolley, et al.*)

Section 615, act of 1928, amending sec. 177 of the *Judicial Code*, as amended, is not retroactive, and interest on a judgment for the recovery of a tax rendered by the supreme court in 1927 is allowable under sec. 1117, act of 1926, amending

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sec. 177 of the *Judicial Code*, to the date of entry of the final judgment. (U. S. court of claims, *The S. S. White Dental Mfg. Company of Pennsylvania v. United States*.)

Liability for breach of a contract as established by a judgment rendered in a subsequent year is deductible in the year of the breach by a taxpayer on the accrual basis who set up on its books a reserve for such liability in the year of the breach, such liability being created by the breach of the contract, and not by the admission of liability therefor to the creditor. (U. S. circuit court of appeals, second circuit, *American Code Company, Inc., v. Commissioner*.)

Income received in 1919 and 1920 by a trust and added to the corpus pursuant to a trust deed providing for distribution of the income thereof at the discretion of the trustee or upon demand by the majority of the beneficiaries, no demand for distribution having been made, is taxable to the trust as income held for future distribution. (District court of the United States, western district of Missouri, *C. S. Jobs, trustee of C. S. Jobs Trust Estate, v. Noah Crooks, collector*.)

Contract held to be a licence for the use of a secret process and not a sale of such process, and the payments received under it are income and not a realization of capital. (U. S. court of claims, *Charles E. Kaltenbach v. United States*.)

Invested capital for 1918 should not be reduced on account of a tentative tax computed upon income for that year in determining the amount of current earnings available for the payment of dividends. (U. S. circuit court of appeals, third circuit, *Commissioner of internal revenue v. Pittsburgh Knife & Forge Co.*)

Payments to cover expenses and losses incident to the sudden cessation of work on government contracts and return to the regular line of manufacture received under supplemental agreements canceling war contract should be offset by expenditures necessary to effect resumption of peace-time activities. The taxpayer's proof as to such expenses and losses, which could not be segregated on its books, consisting of the uncontradicted testimony of its vice-president in charge of the negotiation with the government and the reconstruction of the plant, stricken out in the hearing before the board of tax appeals on the ground that the books were the best evidence, and was held to be adequate. The board erred in holding in B. T. A. Dec. 2776, 7 B. T. A. 1277, noted at Par. 3311.06a, Vol. II, that any part of the payments received under the supplemental agreements should be subject to the higher rates of sec. 301(c), act of 1918, and the decision was reversed and remanded. (U. S. circuit court of appeals, second circuit, *R. Hoe & Co., Inc., v. Commissioner*.)

Contributions in 1921 to the Y. M. C. A., the Y. W. C. A. and to a hospital are not deductible as ordinary and necessary business expenses by a corporation. (U. S. court of claims, *Alfred J. Sweet, Inc., v. United States*.)