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## Income-tax Department

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# Income-tax Department

EDITED BY STEPHEN G. RUSK

To the readers of this department we offer our apologies with profound regret for an error in the August number of *THE JOURNAL OF ACCOUNTANCY*, wherein it was asserted by us that a claim for refund and an assertion of a deficiency on account of a 1925 tax return could be made as late as March 15, 1930.

Our explanation of the error is that we unwittingly presumed that the 1925 income-tax was imposed under the provisions of the act of 1924, instead of that of 1926. This latter act became retroactive to January 1, 1925, and, therefore, the statute of limitations of the latter act took precedence over that of the 1924 act. Under the provisions of the 1924 act a taxpayer had four years from the statutory date of making a return within which to file a claim for overpayment, whereas the 1926 act reduced this period to three years from the statutory date of making the return.

Since the issuance of the August edition of *THE JOURNAL OF ACCOUNTANCY* a considerable number of letters has been received by us demanding an explanation of our palpable error, and in these paragraphs we wish to express our regret that it was made.

It seems appropriate to state that our sympathies have been invoked, because of this experience for students who are obliged to solve abstract propositions in the examinations to which they are subjected. With a concrete question before us as to a claim for refund for the year 1925, the tax return for that year would have been consulted, which would have put us on notice that it was made under the provisions of the act of 1926. However, in dealing with abstract questions as to former years' tax matters it is easy to forget the effective date of each of the several taxing laws.

In the John Doe case, our comments upon which has led to all this trouble, it appears that the taxpayer had made his claim for refund before March 15, 1929 (which was within the statutory period for making such claims) and after the claim was made and after March 15, 1929, a revenue agent appeared at the taxpayer's office and found an excessive deduction for depreciation of an amount equal to that upon which the claim for refund had been based.

Section 277 (a) (1) of the act of 1926 reads as follows:

"The amount of income taxes imposed by this act shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period."

In the case of John Doe, no waiver of the statute of limitations was asked nor furnished, and, therefore, March 15, 1929, seems to have been the last date upon which any assessment for a deficiency could be made.

It is proper to state that the claim for deficiency was not filed, in John Doe's case, until March 12, 1929, and that the commissioner probably had no opportunity prior to March 15th of that year to examine the accounts of the taxpayer. Furthermore, it is presumable that if in examination of John Doe's claim for refund the commissioner found offsetting errors which canceled the amount of the taxpayer's alleged reduced income the statute of limitations

could not be invoked as a bar to the correction of such errors as involved additional taxes.

It is interesting to draw attention to a number of cases where deficiencies have been the subject of contention until after the statute of limitations for refunds had expired; where not only was the asserted deficiency disallowed but an amount of deduction allowed by the board of tax appeals greater than that taken in the return, and, upon the taxpayers making claims for refund at the termination of the case, they were informed that as the period in which such claims could be made had expired, no refund could be allowed.

It is difficult for the taxpayers to comprehend why the government can find additional taxes after the statute of limitations has expired, to offset claims for refund made before such expiration, when, on the other hand, the taxpayer is estopped from collecting refunds for overpayment of taxes found in the course of contending against the assessment of a deficiency, when such assertions of deficiencies ultimately have been found to be erroneous after the expiration of the statutory period for claiming such refunds.

Robert H. Lucas, commissioner of internal revenue, was one of those kind enough to write us as to our regrettable error in the August number. We feel that all our readers will appreciate his interest in our profession in directing our attention to the correct solution of the problem presented by the case of John Doe.

It is with pleasure that we quote his letter in full:

*Editor, THE JOURNAL OF ACCOUNTANCY*

SIR: Attention is invited to the article on federal income tax appearing on pages 135 and 136 of the August, 1929, issue of THE JOURNAL OF ACCOUNTANCY. This article contains a criticism of the "machinery" provided in the revenue laws for the administration thereof, such criticism being based upon a discussion of the law and procedure applicable to a particular case.

The statements in the article relative to the law and procedure applying thereto are incorrect. A correct statement of the law and procedure involved in the particular case discussed is, therefore, submitted for your information.

Briefly stated the case discussed concerned a taxpayer who had omitted a certain allowable deduction from his return for 1925 and subsequently filed a claim for refund of the overpayment of tax resulting therefrom. The claim was audited by a revenue agent who found that the taxpayer had overstated another deduction by an amount equal to that omitted from the return. The net income and tax liability originally reported, therefore, were neither decreased nor increased as the result of these adjustments inasmuch as the items offset each other. Accordingly, the examining officer informed the taxpayer that no refund of tax would be made.

In the discussion of this case the article in question states the law and procedure applicable thereto as follows:

"Under the acts of 1924 and 1926, the taxpayer has until March 15, 1930, to make a claim for refund of overpayment of income tax returned for the year 1925. The commissioner has until March 15, 1930, to assess a deficiency of tax if found by him in a 1925 tax return. In view of the fact that the settlement of the question of overpayment and deficiency of tax can be made as late as March 15, 1930, it is presumed that in due course John Doe will receive from the commissioner an answer to his claim for refund.

"He will also receive from the commissioner prior to March 15, 1930,

an assertion of a deficiency because of the excessive depreciation. Then he will have just sixty days within which to appeal to the United States board of tax appeals against the assessment of the deficiency. If he thus appeals he will then wait a year or two before the board gets to his case. In the meantime, the commissioner will withhold payment of the refund until the whole matter has been adjudicated by the board."

The statements that the period for filing a claim for refund of an overpayment of tax for 1925 and the period for assessment of a deficiency in the tax for such year extended until March 15, 1930 are incorrect. The statements presumably are based upon the provisions of section 281 (b) of the revenue act of 1924, under which the statutory period of limitation for filing claims for refund expired four years from the date the tax was paid, and section 277 (a) (1) of that act, under which the statutory period for making additional assessments of taxes expired four years from the date the return was filed. Inasmuch as returns for 1925 were filed in general on or about March 15, 1926, at which time either the entire tax or the first quarterly instalment thereof was paid, the statutory period of limitation upon refund and assessment for 1925 would have extended to March 15, 1930, had such provisions of the revenue act of 1924 not been repealed or superseded by the revenue act of 1926, and the statements made in respect thereto in the article would have been correct.

Returns for 1925 are, however, subject to the provisions of the revenue act of 1926, which although enacted on February 26, 1926, is retroactively effective as of January 1, 1925. Under section 284 (b) (1) of the revenue act of 1926, the period of limitation upon filing claims for refund of taxes imposed by the revenue act of 1926 is reduced to three years from date of payment of the tax. Consequently, unless subject to certain exceptions provided in the statute, such period with respect to the year 1925 expired on March 15, 1929, if the tax was paid in one sum. If the tax was paid in quarterly instalments, then such period terminates in respect of each instalment thereof on March 15, June 15, September 15, and December 15, 1929. Likewise, by section 277 (a) (1) thereof the period of limitation upon assessments is reduced to three years from date of filing the return and such period, unless extended by a form of consent or other statutory provision, expired in general on or about March 15, 1929 with respect to returns filed for the calendar year 1925.

The statements that in closing John Doe's case it will be necessary to assert a deficiency in tax as the result of the item disallowed as a deduction and that, consequently, if an appeal is filed with the United States board of tax appeals the refund of the overpayment of the tax resulting from the deduction originally omitted from the return will be held in abeyance until the whole matter has been adjudicated by the board, are also incorrect.

The statute provides that if upon examination of a return the tax liability determined by the bureau is in excess of the tax already paid, a deficiency results which may be made the subject of an appeal to the United States board of tax appeals. The board then has jurisdiction to decide all issues and redetermine the tax liability. Its decision is final, subject, however, to review by the courts. On the other hand, if the tax liability determined by the bureau is less than the tax already paid an overpayment of tax results, which may be refunded or applied as a credit against an outstanding liability for another year. In that event, the board does not have jurisdiction to redetermine the tax liability should the taxpayer disagree with the bureau's determination. The taxpayer, however, is not without a remedy and may file a refund claim upon the disputed questions which, upon rejection by the bureau, can then be carried to the courts for adjudication. Thus it will be observed the statute does not require an assessment of a deficiency and allowance of a refund for the change in tax liability occasioned by each and every adjustment to a return but instead the "machinery" of the law is put into motion by and operates only upon the net change in tax liability resulting from all of the adjustments made with respect to the return.

Applying the foregoing to the case of John Doe, it will be noted that inasmuch as the tax liability determined by the bureau was not in excess of the tax previously paid the case could not be carried to the United States board of tax appeals for redetermination of a deficiency. Moreover, inasmuch as the tax liability so determined was not less than the tax paid the taxpayer's claim for refund could not be allowed. Consequently, in closing the case it would be necessary for the bureau merely to issue a letter in rejection of the claim for refund. The matter then would be closed unless the taxpayer did not agree with the bureau's determination of the tax liability, in which event, as already stated, the rejection of the claim gives the taxpayer the right to bring a suit in court upon the disputed issues.

Yours truly,

August 28, 1929.

(Signed) ROBT. H. LUCAS,  
Commissioner of Internal Revenue.

#### SUMMARY OF RECENT RULINGS

Personal-service classification allowed a taxpayer conducting a produce and fruit commission business. (Circuit court of appeals, fourth circuit. *Atlantic Coast Distributors v. Commissioner.*)

The worthlessness of a debt is held not established where the debtor is a person of large earning capacity, owns considerable property, and has a high standing as a citizen and public officer.

A stockholder's loss on the stock of an insolvent corporation is deductible in the year the corporation is adjudged insolvent.

Failure to establish cost of stock precludes deduction of loss. (District court of the U. S., western district of Pennsylvania. *In the matter of John A. Bell, bankrupt.*)

A taxpayer on the accrual basis entitled to receive extra compensation from the employing corporation's net profits, having bound himself to invest such compensation in the corporation's stock which is to be held in trust for him during the term of his employment, should report compensation used to purchase the stock as income for the year the purchase was made. (U. S. district court, southern district of New York. *O. Victor Rodrigues, plaintiff v. William R. Edwards, former collector of internal revenue for the second district of New York.*)

An inventory valuation at December 31, 1917, based on "normal cost which would approximate values of 1915" is not an inventory valued at cost. (*Western Dry Goods Company v. U. S. of America.* U. S. district court, western district of Washington, northern division.)

An amount credited to the account of a deceased employee in consideration of his long and faithful service is held to be an ordinary and necessary business expense deductible in the year credited. (U. S. district court, eastern district of Pennsylvania. *Philip Wunderle v. Blakely D. McCaughn, collector.*)

A return on the calendar-year basis filed by a taxpayer keeping books on a fiscal-year basis does not start the running of the statute of limitations, which does not begin to run until a return or returns are filed which at least purport to cover the period involved, and where two returns are filed each including a part of the taxable year the statute does not run until a return or returns are filed which at least purport to cover the period involved, and where two returns are filed each including a part of the taxable year the statute does not run until it expires as to both returns. (U. S. circuit court of appeals for the ninth circuit. *Paso Robles Mercantile Company v. Commissioner.*)

An amount in settlement of patent-infringement claims paid to a corporation and by it distributed as dividends to another corporation, its sole stockholder, as a means of effecting the distribution to the stockholders entitled thereto, is not taxable to the second corporation, where the first corporation was legally obligated to pay the said amount to its former stockholders, the second corporation after its payment standing in the same financial condition as though the amount had been paid by the first corporation direct to its former stockholders.

## *Income-tax Department*

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(U. S. district court, northern district of New York. *AnSCO Photo Products, Inc., v. Jesse W. Clark, collector.*)

The payment by an employer of the income taxes assessable against an employee constitutes additional assessable income to such employee. (U. S. circuit court of appeals, first circuit. *Old Colony Trust Company, et al., executors, v. Commissioner.*)

Under a partnership agreement it was stipulated that a future incorporation of the business was to take place to be based on the capital invested in the business by the partners as evidenced January first previous by a private ledger to be kept by one of the partners; that one seventh of the total stock issued by the corporation was to revert to one partner; that the remaining six sevenths were to be divided between the other three partners as their interests might appear from said private ledger. Held that when subsequent to incorporation a sum was transferred on the corporation's books to cover the issuance of a one-seventh interest to the partner first mentioned, such action was proper, and that the gross estate of one of the other three partners, then deceased, should be determined without including the amount represented thereby. (U. S. district court, eastern district of New York. *DeWitt A. Davidson, as successor, etc., v. John T. Rafferty, collector.*)

A waiver covering the limitation period for refund of prior year taxes paid by a corporation merged with another corporation is valid where the waiver was executed and filed by the new corporation, the merger under Pennsylvania laws being merely a readjustment of the relation of the original shareholders among themselves. (U. S. circuit court of appeals, third circuit. *D. H. Phillips, collector, v. The Lyman H. Howe Films Company.*)

A lessee under a lease requiring maintenance and restoration of property of a like quantity to that leased is not allowed deductions for depreciation on such property or for claimed losses on any of such property sold or otherwise disposed of at prices below the amounts itemized in the lease agreement. (U. S. circuit court of appeals, sixth circuit. *Ohio Cloverleaf Dairy Co. v. Commissioner.*)

A new corporation resulting from the consolidation of several corporations, having taken over the assets and assumed the liabilities of the old corporations, while technically a distinct legal entity, is to all practical intents and purposes a mere continuation of the old corporations and is entitled to the same deduction on account of amortized bond discount that one of the old corporations would have been entitled to if the reorganization had not taken place. (U. S. circuit court of appeals, fourth circuit. *Western Maryland Railway Company v. Commissioner.*)

The two principal stockholders of an undissolved corporation are liable as distributees under the trust-fund doctrine for unpaid income taxes of the corporation, where such stockholders have caused all the valuable assets of the corporation to be transferred to a partnership consisting of such stockholders, even though no judgment for the outstanding taxes has been obtained against the corporation and even though it is not made a party to the action for recovery from the stockholders. (District court of the United States, eastern district of Oklahoma. *United States of America v. Joseph Tandy Courts, et al.*)