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Income-tax Department

EDITED BY STEPHEN G. RUSK

If an accountant is ambitious to augment his education he should give careful attention to the workings of "the legal mind." We know of nothing that has been of such edification to us as is the careful contemplation of legal decisions in federal tax matters. Heretofore some observations have been made in this department as to fearful and wonderful decisions that have been handed down, but very recently a decision has been brought to our attention that is so apropos of the subject of the peculiar results arrived at by the operating of much legal thinking, that we deem it not unwise to make comment on it.

A taxpayer acquired by gift in 1917 stock of a new corporation that was then being sold for $100 a share, its par value. Because the corporation was formed to enter a comparatively new and then untried field of business (the financing of automobile notes), the value of the stock was speculative. The corporation incurred a large promotion and financing cost in disposing of its stock, and this cost was entered on its balance-sheet as promotion cost. For various reasons the company's earnings did not come up to expectations during the three subsequent years, and the taxpayer sold her stock in 1920 for $21 a share. As she had reasons to believe that the value of the stock at date of its acquisition was in excess of $21 a share, she made no return of income for the year 1920—the sale of stock constituting her only income.

Some years later the commissioner decided that the stock had a value of $2.85 a share at date of its acquisition and that the difference between $21 a share and the said $2.85 was taxable income, and that the taxpayer incurred the prescribed penalty for failure to make a return. In this relation an interesting fact to keep in mind is that the commissioner had determined that the fair value of the stock for capital-stock purposes at about the date taxpayer acquired the stock, was about $20 a share. This case was carefully gone into by the commissioner at the behest of the taxpayer, but as no agreement could be reached it was appealed to the United States board of tax appeals. After the usual hearing and a delay in reaching a decision of over a year, the board decided that the value of the stock at date of its acquisition was $10.85 a share; that the difference between this amount and the $21 selling price was taxable income and that the taxpayer was subject to a 25 per cent. penalty for failure to make a return.

To those of the legal profession there is nothing astonishing in the foregoing decision, but to those of us not versed in their lore, it is puzzling at least as to why the penalty was asserted, for the taxpayer had the following reasons to believe the fair value of the stock at date of its acquisition was as great or greater than the selling price:

1. It was being sold for $100 a share in substantial quantities.
2. The commissioner, after reducing the value of the promotion and financing asset by a large amount, found a value for capital-stock purposes at or about date of its acquisition of about $20 a share.
3. A balance-sheet of the company showed capital and surplus to aggregate $102.85 a share.

How many taxpayers, confronted by these facts, would have made a return or would have thought that they had received taxable income? And, as there were so many varied attempts to arrive at the fair value of this stock by the commissioner with varying results, why should the taxpayer be on notice of just what value would finally be determined by so many giving it thoughtful consideration?

By an interesting coincidence, undoubtedly, the value of the stock finally determined by the board was identical with an unaccepted compromise offer made by the commissioner some years prior to the final decision.

SUMMARY OF RECENT RULINGS

Where, in a large inventory, articles identified by stock number were listed by departments, the cost price and year of purchase of each article being shown, a discount being taken on certain departments as a whole, and the testimony showing that such method was favorable to the government, the value which was returned will not be disturbed.

Salaries shown by uncontradicted evidence to be reasonable for actual services rendered and similar to those in competing businesses are allowable deductions. (United States district court, district of Maine, N. D., *Wood & Ewer Company* v. *Frank J. Hain, collector.*)

A husband's assignment to his wife of half of his share of partnership income did not relieve him from liability for income on the entire share. (Circuit court of appeals for second circuit, *Ormsby McKnight Mitchel* v. *Frank K. Bowers, collector.*)

To the extent of value of corporate assets acquired by stockholder on dissolution or expiration of corporation, he is liable for its debts, although there was no formal transfer of assets. (Circuit court of appeals, fifth circuit, *Capps Manufacturing Co.* v. *United States of America.*)

Provisions of section 1106 (a) of 1926 act, that expiration of limitation period against the United States for assessment and collection of taxes shall extinguish the tax liability, does not operate to destroy the effect of section 3224, *Revised Statutes*, which prevents the enjoining of any assessment or collection proceeding of the government.

If collection of the tax was illegal, the right thereto having been barred by limitation, a waiver given to prevent advertisement for sale under distraint, involving destruction of credit, etc., should be canceled by a court of equity. (United States district court, E. D. of Virginia, *Thornhill Wagon Company* v. *John C. Noel, collector.*)

Gains from an illegal business were taxable under the 1921 act.

The 1921 act does not furnish immunity to one who makes incriminating disclosures in the income-tax return required.

Privilege against incrimination in fifth amendment to constitution is a complete defense to an indictment charging failure to file return, when such a return would disclose earning of income in commissions of crime. (Circuit court of appeals, fourth circuit, *Manly S. Sullivan* v. *United States.*)

Value for capital-stock tax should not include goodwill which is dependent solely on the continuance of the life of an individual and the friendly feeling toward him of another company. (United States district court, district of Massachusetts, *Noyes Buick Co.* v. *Malcolm Nichols, collector.*)

Earned surplus may be included in invested capital, under sec. 326 (a) of 1918 act, notwithstanding a prior operating deficit of the corporation had not been made up. (Circuit court of appeals, eighth circuit, *Milton Dairy Company* v. *L. M. Wilcutts, collector.*)

A deed to grantor's children for the life of the survivor, then to grantee's descendants for 21 years, and then in fee to such descendants, is not a transfer to take effect at or after death. (United States district court, E. D. Pennsylvania, *Fidelity Trust Company, et al., co-administrators,* v. *Blakely D. McCaughn, collector.*)

Amount left by will as full payment of allowances for "acting as my executor" is not a non-taxable bequest but taxable income to the recipient. (United States district court, S. D. of New York, *Robert C. Ream* v. *Frank K. Bowers, collector.*)

A trust formed before the enactment of an estate-tax law, the grantor dying in October, 1919, having retained the right to alter or revoke, is taxable under the 1918 act as a gift to take effect at or after death. (United States district court, S. D. of New York, *Farmers Loan & Trust Company, trustee,* v. *Frank K. Bowers, collector.*)

Where a partnership made a loan in German marks which remains unpaid, one of the partners may not under the 1918 act claim any deduction on account of depreciation in the value of the mark. (United States district court, S. D. of New York, *George Haviland* v. *William H. Edwards.*)

TREASURY RULINGS

(T. D. 3931, October 9, 1926)

ARTICLE 23: Bases of computation.

Income taxes—Revenue act of 1918—Decision of court

RETURNS—CASH OR ACCRUAL—FISCAL YEAR

A corporation which kept its books upon an accrual basis and filed returns upon a fiscal year basis beginning June 1, 1917, can not under section 212 (b) of the revenue act of 1918 file a return for the period June 1, 1917, to December 31, 1917, on a cash basis and for the period January 1, 1918, to June 1, 1918, on an accrual basis, the statute requiring that the returns must be filed and the tax computed in accordance with the method regularly employed in keeping its books, which in the instant case is the accrual basis.

The following decision of the United States district court for the southern district of New York in the case of *W. S. Barstow & Co., Inc.,* v. *Bowers, collector,* is published for the information of internal-revenue officers and others concerned.

UNITED STATES DISTRICT COURT, SOUTHERN DISTRICT OF NEW YORK

W. S. Barstow & Co., Inc., plaintiff, v. *Frank K. Bowers, collector of United States internal revenue for the second district of New York, defendant*

[September 14, 1926]

AUGUSTUS N. HAND, district judge: This is an action to recover federal income taxes alleged to have been unlawfully exacted and paid under duress. It was tried before a jury of one and at the close of the evidence the defendant moved for the direction of a verdict in his favor, and plaintiff moved for the direction of a verdict of $25,808.24, with interest from March 27, 1923, the amount demanded in the complaint. Upon the question of law thus presented decision was reserved and elaborate briefs have been since submitted.

The plaintiff always kept its books on an accrual basis and until 1918 its federal income-tax year was the calendar year. It made all its tax returns on a cash basis up to January 1, 1917. About that time it obtained permission from the commissioner of internal revenue to change from the calendar year basis to the basis of a fiscal year beginning June 1, 1917, and ending May 31, 1918. The taxpayer rendered a return for the period between January 1, 1917, and May 31, 1917, on the accrual basis. During the fiscal year from June 1, 1917, to May 31, 1918, collections were very slow because business was bad and in making the return for the fiscal year it was made on a cash basis. The income so returned was $11,063.45 and the tax amounting to $617.76 upon such basis was thereupon paid. Later in the year 1918 the revenue act of 1918 was passed which, in section 205 (a), reads as follows:

"That if a taxpayer makes return for a fiscal year beginning in 1917 and ending in 1918, his tax under this title for the first taxable year shall be the

sum of (1) the same proportion of a tax for the entire period computed under title I of the revenue act of 1916 as amended by the revenue act of 1917 and under title I of the revenue act of 1917, which the proportion of such period falling within the calendar year 1917 is of the entire period, and (2) the same proportion of a tax from the entire period computed under this title at the rates for the calendar year 1918 which the portion of such period falling within the calendar year 1918 is of the entire period.

"Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by title I of the revenue act of 1916 as amended by the revenue act of 1917, and by title I of the revenue act of 1917, shall be credited toward the payment of the tax imposed for such fiscal year by this act, . . ."

The plaintiff after the passage of the act of 1918, and claiming to proceed in accordance with its provisions, filed an amended return computing the tax for the seven months of 1917 on a statement made for those months upon a cash basis and for the five months of 1918 on a statement made for those months on an accrual basis.

The income for the fiscal year already calculated on a cash basis was $11,063.45 and the tax under the 1917 rates was $617.76. The income for the fiscal year on an accrual basis was calculated at $91,337.72 and the tax thereon under the 1918 rates was $48,769.15. Plaintiff added seven-twelfths of the above sum of $617.76 to five-twelfths of the sum of $48,769.15 and found a total tax due as thus calculated for the fiscal year ended May 31, 1918, in the sum of $20,680.84, and paid such sum to the collector. The commissioner recalculated the income and found it on an accrual basis to be $95,606.88 instead of $91,337.72. The commissioner objected to plaintiff's method of computing the tax for the first seven months upon income calculated on a cash basis and made an additional assessment for that period on an accrual basis whereby the tax was ultimately fixed by him at the further sum of $24,438.25, involved in this action.

The plaintiff's contentions are:

1. That under subdivision (1) of the law heretofore quoted, the income should be computed, as well as the rates of tax applied, entirely under the 1916 and 1917 acts and as if the plaintiff's fiscal year had coincided with the calendar year 1917.

2. That under the 1916 and 1917 acts, the plaintiff had a right to make its return and have its income computed on the basis of actual receipts and disbursements and the commissioner had no right to change the return to an accrual basis.

In other words, because under the act of 1917 the plaintiff had a right to file its tax return on a cash basis, it argues that it may still do so under the provisions of section 205 (a) of the revenue act of 1918 for the first part of its fiscal year.

The government, on the other hand, claims that:

1. The revenue act of 1918 requires the taxpayer's income to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer and regardless of whether the taxpayer's accounting period is a fiscal year or a calendar year.

2. Having once elected to file its return on the accrual basis, it can not return to the cash basis for the purpose of the first part of its fiscal year ending May 31, 1918.

3. The commissioner, under the revenue act of 1916, as amended by the act of 1917, could require the taxpayer to make its return on the accrual basis.

4. The accrual basis reflects plaintiff's true net income.

Now, section 212 (b) of the act of 1918 provides how net income shall be computed, and reads as follows:

"(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping

the books of such taxpayer; but 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. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year."

Section 200 above referred to reads as follows:

"SEC. 200. That when used in this title—

"The term 'taxable year' means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term 'fiscal year' means an accounting period of 12 months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1918, shall be the calendar year 1918 or any fiscal year ending during the calendar year 1918;"

I can hardly see any question about the meaning of these sections. They inevitably lead to the conclusion that the revenue act of 1918 requires a taxpayer filing a return for a fiscal year ending in 1918, as here, to compute its net income for the entire period in accordance with the method regularly employed in keeping its books, which was here the accrual method. Section 212 (b) requires it to be computed upon the basis of the taxpayer's annual accounting period in accordance with the method regularly employed in keeping the books when it is a fiscal year as defined in section 200, and that section provides that the first taxable year to be called the taxable year 1918 shall be the calendar year 1918, or any fiscal year ending during the calendar year 1918.

Article 1622, regulation 45, provides in part as follows:

"The method provided for computing the tax for a fiscal year beginning in 1918 and ending in 1918 is as follows: (*a*) the tax attributable to the calendar year 1917 is found by computing the income of the taxpayer and the tax thereon in accordance with title I of the revenue act of 1916 as amended and title I of the revenue act of 1917, and determining the proportion of such tax which the proportion of the fiscal year falling within the calendar year 1917 is of the full fiscal year."

This is relied on by the plaintiff and particularly the words "by computing the income of the taxpayer" as showing that the old method in vogue prior to the act of 1918 of computing the income upon a cash basis was incorporated in the regulation. I think the position of the government as to this regulation is correct and that it has nothing to do with the basis to be used in computing the income, but was only aimed at a recognition of the deductions and exemptions peculiar to the year 1917 which should be applied in arriving at the net income for the whole period. The tax would then be calculated on this net income at the 1917 rates and the proportion of such tax that the part of the fiscal year falling within the year 1917 bore to the whole period would represent the tax for the months of 1917.

It is obvious that any other construction of the regulations and the act would exempt from taxation all accruals which were not paid during the part of fiscal year within the calendar year of 1917. It would in this case avoid a tax on seven-twelfths of the difference between the income of $11,063.45 and $95,606.88, or $84,543.43. There is little doubt, moreover, that article 23 of *Regulations 75*, as amended by treasury decision 2873 [C. B. 1, 58], would always enable the commissioner by requiring amended returns for previous years to secure payment of a tax on any income omitted by reason of a change of method employed in keeping his accounts of income; but I see no reason upon the facts before me for requiring this if the government is satisfied with the present data. Indeed, this regulation which simply enabled a true statement of income to be made indicates that the commissioner could require payment of the additional tax based on a complete return.

Moreover, I think it reasonable to suppose that the provisions of section 13 (d) of the act of 1917 which permitted a taxpayer who kept accounts upon any

basis other than that of receipts and disbursements to make its return upon the basis upon which its accounts were kept required consistency. Plaintiff had changed from a cash basis in use prior to 1917 to an accrual basis for the first five months of that year. This change when made should be adhered to in order to prevent loss of taxable income and to reflect the true amount. That the accrual system more nearly than any other in fact reflected the true income in this case scarcely admits of discussion. Perhaps in 1917 the plaintiff's accounts appeared to be doubtful but they were not so carried on its books and were all afterwards collected.

Plaintiff's contention that the acts prior to 1918 in a general way required computation of gross income and deductions therefrom upon a cash basis is unimportant if true. It is answered not only by the voluntary change of plaintiff to an accrual basis, which when made should have been adhered to, but more especially by the terms of the act of 1918, which placed the plaintiff's returns upon an accrual basis because its books were so kept, and in such circumstances under sections 200 and 212 (b) that basis governed us to "any fiscal year ending during the calendar year 1918."

Accordingly a verdict should be directed for the defendant.

(T. D. 3932, October 9, 1926)

ARTICLE 154: Worthless securities.

Income taxes—Revenue act of 1918—Decision of court

1. DEDUCTIONS—LOSSES—DEPRECIATED VALUES—CLOSED TRANSACTION

Under the revenue act of 1918, shrinkage in the value of a loan repayable in German marks caused by the falling value of such marks can not be deducted from gross income as a loss incurred in trade or business or as exhaustion, wear, tear or obsolescence until the transaction is closed either by repayment or cancellation of the loan.

2. DEDUCTIONS—PARTNERSHIP LOSSES

The fact that a partnership on its books for invested-capital purposes and excess-profits tax reduces to its present value an unpaid loan of German marks at the depreciated rates does not furnish any ground for a deduction by a partner in his individual tax return.

The following decision of the district court of the United States for the southern district of New York in the case of *George Haviland* v. *Edwards, former collector*, is published for the information of internal-revenue officers and others concerned.

DISTRICT COURT OF THE UNITED STATES, SOUTHERN DISTRICT OF NEW YORK

George Haviland, plaintiff, v. *William H. Edwards, defendant*

Motion to dismiss complaint

[September 7, 1926]

HAZEL, district judge: In this action plaintiff seeks recovery from the collector of internal revenue of $23,622.21, illegally collected as income tax for the year 1919, and the additional amount of $1,307.40 for the year 1920. There are six actions of like nature, three brought by plaintiff individually against successive collectors for income taxes paid in 1918 and other periods, and three by plaintiff as ancillary administrator of Charles S. Haviland, who, in his lifetime, was a copartner of plaintiff, the partnership doing business in New York City under the name of Haviland & Co., as dealers in importation of chinaware from Limoges, France. Defendants moved to dismiss the complaint in each case on the ground that no cause of action is alleged. It is alleged in the com-

plaint that before January 1, 1918, the partnership loaned to Johann Haviland, a resident of Germany, 1,110,000 German marks of the current value, in this country in 1916, of $263,524.79, and in 1919 an additional loan to the same person of 400,000 German marks of the current value of $16,600.26, which were to be repaid in marks and which were entered in the books of the company as current assets to the amount of $280,125.05, constituting the cost price of the marks, and which amount was inventoried and returned by the lender as profits in its income-tax return for the year 1920. The difference between the cost in dollars and the actual value of the mark in United States currency was $30,653, making a difference between cost and actual value of $249,472.05. It appears that after filing the tax return, the books of the partnership were audited by the commissioner of internal revenue to establish an amount for income tax and excess profits payable for the year 1917, and, as a result of the audit, the value of the current assets was depreciated by the commissioner and the marks given a value at the current rate of exchange prevailing at the time. Upon this basis the partnership paid its income tax for the year 1917, but in August, 1922, filed an amended tax return indicating that the profits for 1919, based upon the actual value of the marks, was $95,362.14, instead of $228,792.03. The plaintiff filed his individual income-tax return for 1919, based upon the proportionate profits of the partnership at the amount of $228,792.03, which included the cost of the marks instead of their current value or the alleged actual profits, but in October, 1922, he filed an amended tax return basing his proportionate share of the profits on the actual value of the marks, which resulted in a reduction of the profits of the firm for 1919 from $228,792.03 to $95,362.14. According to the amended return, plaintiff alleges that the proper tax should have been $6,161.60 instead of $29,783.81, the amount previously paid by him. In November he filed a claim for refund of the excessive sum paid by him, but his claim was rejected. The second cause of action is based upon a similar allegation for excessive income taxes paid for the year 1920, and rejection of his claim for refund.

The question presented for decision is concededly one of law, and turns upon whether plaintiff, as an individual, has the right to deduct from his gross income the depreciated value of the German marks loaned to Johann Haviland, a loan which has not as yet been repaid. The income tax was computed pursuant to section 214 of the internal-revenue act of 1918, which in terms is limited to a computation of a net income as to deductions from losses sustained during the taxable year, and not compensated for by insurance or otherwise, if incurred in trade or business; and also to a reasonable amount for wear and tear of the property used in the trade or business including a reasonable allowance for obsolescence. It is not alleged that the marks have been repaid at any depreciated value, or that they have become of no value, or have been disposed of at a loss to the partnership or to the plaintiff, or that his proportionate individual profits have been decreased and a loss sustained. The mere fact that the field auditor who examined the books of the partnership in 1917 for the commissioner of internal revenue to ascertain whether the copartnership was assessable for excess-profits tax required or suggested reduction of the current value of the marks to their equivalent value in this country, and in doing so diminished the invested capital, increasing the income tax, does not, in my opinion, furnish a proper basis for plaintiff's taxation or deduction from gross income. His income tax is not owing to any trade or business carried on by him, though an incident of the copartnership. As already pointed out, he suffered no loss or cancellation; indeed, no closing of the transaction is alleged. I think the recent decision by the supreme court of the United States in *New York Life Insurance Co.* v. *Edwards* in principle is analogous to the case at bar; and the circuit court of appeals for this circuit in that case ruled that under the act of 1913, an act similar to the provision herein considered, the depreciation of securities which had not been sold during the year, comes neither under the clause relating to "depreciation of use, wear and tear" nor "loss actually sustained." The facts in that case, true enough, were different from the facts here; nevertheless, it is clear that the ground for income deduction must be losses actually sustained within the taxable year. Any

shrinkage of the value of the German mark is obviously akin to depreciation in value of stocks and bonds, and without an actual loss a taxpayer is not entitled to a deduction from the gross income under the act of 1918. Such has also been the holding of the board of tax appeals (James S. McCandless, docket 2782, April 23, 1926, B. T. A.), and I think the position taken by counsel for the defendant in this relation is correct; and the argument has force that the loan of the marks by the copartnership was substantially the same as though it had been made by plaintiff individually. He has the right to receive back the money loaned as agreed. His individual income may, to an extent, be based upon the proportionate share of the net income of the partnership, but he must show, notwithstanding, an individual loss before his claim for a deduction can be realized. The income-tax law, it is true, required plaintiff, as a partner of the firm, to file a return for each taxable year and supply the information upon which the tax is assessed (secs. 918, 924, 321, 322, of the revenue act of 1918), but his guide for making his return does not require reliance upon the book entries of the copartnership or balancing of its books, or upon any entry indicating a depreciated value of the marks. The income tax in question was not erroneously collected, and, accordingly, the motion of the defendant to dismiss the complaint in each of the cases submitted is granted.