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Income-tax Department

EDITED BY STEPHEN G. RUSK

No treasury decisions that had reference to income tax were made during the past month.

There have been many decisions by the board of review, by the solicitor of the department, and by the office, from which have been gleaned the more important that bear upon phases of the law that are met with considerable frequency by accountants.

These opinions and decisions, given below, relate to such questions as income from exchange of property, sale of personal property on the instalment plan, and to such deductions as depreciation of intangible property, valuation of inventory, charitable contributions, life insurance premiums, etc.

As the time is at hand when many returns must be made, the matters discussed in the following paragraphs become vitally interesting.

Section 202, article 1563: exchanges of property.
(Also section 213 (a), article 52.) A. R. K. 289

The committee has had under consideration the appeal of A from the action of the unit in proposing an additional assessment of income tax for the years 1916 and 1817.

The additional taxes grow out of the reorganization of the M Company, or rather the formation of the M Company of Delaware, and the exchange of its stock for stock of the M. Company of New Jersey. This exchange was made by giving three shares of the preferred stock of the New Jersey company, not redeemable and carrying dividends at the rate of 7 per cent, for four shares of preferred stock of the Delaware corporation, redeemable at 110 per cent of par and carrying dividends of 6 per cent, and five shares of the common stock of the new company for one share of stock in the old company.

Two questions arise in connection with the pending appeal: one, whether any profit was made, and the other as to the year when the profit, if any, was made. Upon the first question the office has uniformly taken the position that stocks in different companies are essentially different properties, and that a taxable profit is realized if the value of the stock received in exchange is in excess of the cost of the stock so exchanged.

The committee understands that the office has taken a similar stand with respect to other stockholders of the M Company.

The committee therefore recommends that the ruling of the unit, holding the stockholders of the New Jersey company liable for any profit made by exchange of their stock for new stock in the Delaware corporation, be sustained.

Upon the other question it appears that A exchanged a portion of her stock in 1916, but did not take advantage of the offer of exchange as to the rest until 1917. Clearly, although the right to make an exchange had been given her in 1916, no profit accrued to her until she actually made the exchange, and the action of the unit in holding the profit made by exchange subsequent to January 1, 1917, as subject to tax under the rates provided for that year is correct and should be approved.

Section 214 (a) 1, article 101: business expenses. O. D. 711

Office decision 396 (bulletin 6-20), holding that premiums paid on a life insurance policy required as collateral for a loan are deductible as a business expense, is to be strictly construed. The policy must have been taken out for the sole purpose of using it as security for the loan. A taxpayer is not permitted to deduct the premiums paid on a policy taken out prior to the negotiations for a loan and later assigned to the lender as security for such loan. The subsequent assignment of the policy to the lender is merely incidental to the purpose for which the policy was secured, and no additional expense is incurred or loss sustained by virtue of its temporary use as collateral. The increase in the cash surrender value of a policy accruing during the period it is used as collateral is not to be considered in computing the net income of the person who pays the premium.

A corporation which takes out a policy on the life of one of its officers for the purpose of using the policy as collateral may not deduct the premiums paid thereon.

Section 214 (a) 11, article 251: charitable contributions. O. D. 712

Contributions or gifts made within the taxable year to corporations organized and operated exclusively for charitable purposes, which are deductible for income tax purposes from the gross income of individual taxpayers under section 214 (a) 11, revenue act of 1918, have been construed to mean gifts of money or property. The value of services rendered to charitable institutions may not be allowed as a deduction under the aforesaid section.

Section 202, article 1567: exchange of stock for other stock of no greater par value. Sol. Op. 72

INCOME TAX: SECTION 202 (b), REVENUE ACT OF 1918

Article 1567, regulations 45, as amended by T. D. 2870 and further amended by T. D. 2924, applied

The question is raised as to the application of article 1567, regulations 45, as amended by T. D. 2870 and T. D. 2924 in the case of the issue of no-par-value stock under an act of the general assembly of the state of Ohio, approved May 29, 1919.

Section 202 (b) of the revenue act of 1918 provides in part:

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

Article 1567 of regulations 45 as amended by T. D. 2870 provides in part:

So-called "no-par-value stock" issued under a statute or statutes, which require the corporation to fix in a certificate or on its books of account or otherwise an amount of capital or an amount of stock issued which may not be impaired by the distribution of dividends, will for the purpose of this section be deemed to have a par value representing an aliquot part of such amount, proper account being taken of any preferred stock issued with a preference as to principal. * * *

Although this article was further amended by T. D. 2924 the portion quoted remains unchanged.

The specific question presented is whether, if two existing corporations are consolidated under the act of the general assembly of the state of Ohio, approved May 29, 1919, by the exchange of no-par-value shares of the new

corporation for the entire assets and obligations of each of the existing corporations, and they each in turn are liquidated, the no-par-value stock of the consolidated corporation will be held under article 1567 of regulations 45, as amended, to have a par value for federal taxation purposes represented by the aliquot part of the total book value of the properties of the corporations which are consolidated and exchanged for the no-par-value shares in view of the provisions of the Ohio statute limiting the declaration of dividends to surplus profits arising from the business of the new corporation.

An act of the general assembly of the state of Ohio, approved May 29, 1919, provides:

SECTION 1. Upon the formation of any corporation for profit under the laws of this state, * * * the articles of incorporation required by law may provide for the issuance of the shares of common stock of such corporations, without any nominal or par value, by stating in such articles:

(a) The number of shares that may be issued by the corporation, * * *

(b) The amount of capital with which the corporation will carry on business, which amount shall be not less than the amount of the preferred capital, if any, authorized to be issued, and in addition thereto as common capital a sum equivalent to five dollars, or to multiple of five dollars, for each share of common stock to be issued; but in no event shall the amount of common capital be less than five hundred dollars. * * *

Such statements in the articles of incorporation shall be in lieu of any statements prescribed by law as to the amount of the capital stock, and the number of shares into which the same shall be divided, and the par value of such shares.

Each share of such common stock without nominal or par value shall be equal to every other share of such stock, subject to the preferences given to the preferred stock, if any, authorized to be issued. * * *

SECTION 2. No corporation formed pursuant to this act shall begin to carry on business or shall incur any debts until the amount of common capital stock stated in its articles of incorporation shall have been fully paid to the corporation in money or in property taken at its actual value; * * *

No such corporation shall declare or pay any dividend out of capital or which shall reduce the amount of its common capital below the amount stated in the articles of incorporation as the amount of such capital with which the corporation will carry on business. * * *

SECTION 3. For the purpose of any rule of law or of any statutory provision (other than as provided for in this act), relating to the amount of the capital stock of a corporation or the amount or par value of its common shares, the aggregate amount of the capital stock of any such corporation formed or reorganized pursuant to this act shall be deemed to be the aggregate amount, preferred and common, respectively, stated in the articles of incorporation or any amendment thereof, * * * as the amount of capital with which the corporation will carry on business; and for the same purpose the amount or par value of each share of common stock shall be deemed to be an aliquot part of the aggregate common capital so stated in such articles of incorporation or any amendment thereof, or certificates of reorganization. * * *

Section 3 of the act above quoted practically parallels the portion of article 1567, as amended, which is here involved. A careful reading of the portions of the act quoted leaves no room for argument that upon the facts presented the shares of no-par-value stock issued by the consolidated corporation will be deemed to have, for the purposes of federal taxation, a par value representing an aliquot part of the amount of capital with which the corporation is to carry on business as stated in its articles of incorporation.

Under the provision of section 2, quoted, the net value of the assets of the corporations which are consolidated must be not less than the amount of capital so stated, but it is not required to be in excess of that amount. If, in fact, the net value of the assets exceed the amount of capital specified in the articles of incorporation, it is clear that such excess will constitute paid-in surplus out of which dividends might be paid.

It is accordingly so held.

Section 213 (a), article 42: sale of personal property on installment plan. O. D. 715

In the case of sales of personal property where substantial initial payments are made (more than 25 per cent of sale price), article 42 of regulations 45 provides that obligations of the purchasers are to be regarded as the equivalent of cash. It is recognized that in many sales of this type the obligations of purchasers, even though represented by notes or other paper in negotiable form, cannot be discounted or otherwise converted into cash without material loss because of lack of credit on the part of the buyer and the nature of the property covered by such contracts. The obligations of the purchasers in those cases can scarcely be considered the equivalent of cash in any sense, and it is not contemplated by the regulations that such obligations are required to be so treated. On the other hand, the profits from such sales may be computed in accordance with the rule prescribed in cases of the sale or contract for sale of personal property on the installment plan, provided, of course, the taxpayer chooses to do so as a matter of consistent practice, and provided a statement is attached to the taxpayer's return disclosing the fact and showing conclusively that the obligations of the purchasers are not the equivalent of cash.

Section 213 (b), article 80: liberty bond exemption after December 31, 1918. O. D. 718

In case a taxpayer converts his liberty bonds or victory notes originally subscribed for from one denomination into another, or from registered bonds into coupon bonds, or vice versa, he may be considered the original subscriber to the new bonds or notes for the purpose of the collateral exemptions, if the new bonds or notes are of the same issue as the ones originally subscribed for.

Section 214 (a) 8, article 163: depreciation of intangible property. O. D. 721

The following schedule of the terms of patents and trade-marks in various countries is published for the information of taxpayers:

Country	Term of patent	Term of trade-mark
Great Britain..	16 years. Extended from 14 years by act of Parliament, 1919......	14 years renewable.
France.........	5, 10 or 15 years from filing of application	15 years renewable.
Germany.......	15 years from next day after filing.	10 years renewable.
Russia.........	15 years	1 to 10.
Canada........	18 years	General unlimited; special 25 years renewable.
Australia......	14 years	14 years renewable.
Austria........	15 years	10 years renewable.
Switzerland....	10 years for chemical process..... 15 years from filing.............	20 years renewable.
Sweden........	15 years from filing.............	10 years renewable.
Denmark......	15 years	10 years renewable.
United States..	17 years	20 years renewable.

The duration of patent rights in Great Britain was extended from 14 to 16 years in 1919 (see 9, and 9 and 10, Geo. V, c. 80, Chitty, *Annual Statutes*, 1919, p. 423). No corresponding change seems to have been made with respect to trade-marks. Important patent legislation is now pending in France which will radically change the existing law if passed.

The only actual change in duration of patents and trade-marks since 1909 in the countries named seems to have been in Great Britain, as indicated above.

Section 214 (a) 8, article 167: depreciation of patent or copyright. (Also section 326, article 843.) A. R. M. 95

REVENUE ACT OF 1917

The committee has had under consideration the appeal of the M Company, from the action of the income-tax unit in disallowing for the taxable year 1917, an item of $50x$ dollars covering depreciation on certain patents.

In January, 1902, the M Company, then a newly organized corporation, acquired ownership of eight patents issuing therefor to A, the patentee, $900x$ dollars of stock of the corporation. This amount was subsequently increased $2x$ dollars by expenses of acquisition. The patents so acquired, except one, issued in 1900, had expired prior to January 1, 1917, but as of March 1, 1913, all but one were in effect. Fifteen new patents had, however, been added to the company's patents between date of incorporation and March 1, 1913. These additional patents were not capitalized. No depreciation was taken by the taxpayer on the patents which were capitalized, until the year 1917, when 1/17 of the book value was charged to expenses, notwithstanding the fact that all except one of them had expired prior to January 1, 1917.

The taxpayer relies upon articles 167 and 843 of regulations 45, and upon treasury decision 2929, amending article 163 of regulations 45, in support of his action.

It is assumed the actual value at date of acquisition of the patents by the issuance of stock has been determined by the income-tax unit, since this question is not at issue before the committee.

The case then comes clearly under the provisions of article 174, paragraph 552, and article 167, paragraph 494, regulations 33, revised, governing the collection of the income tax imposed by the revenue act of 1917.

Article 174, paragraph 552, provides:

An allowable deduction for any given year for return of capital invested in patents at the time of issue, will be an amount equal to 1/17 of the actual cost in cash or its equivalent of such patents.

This paragraph of article 174 was subsequently amended by advisory tax board recommendation 59, September 9, 1919, to provide as follows:

Depreciation of patents acquired prior to March 1, 1913, should be taken on the basis of their fair market value as of that date, if affirmative and satisfactory evidence of such value is offered.

Article 167, paragraph 494, provides:

Good will represents the value attached to a business over and above the value of the physical property, and is such an intangible asset that it is not subject to wear and tear and no claim for depreciation in connection therewith can be allowed. Any loss resulting from or on account of investment of good will can be determined only when the property or business to which the good will attaches is sold or disposed of, in which case the profit or loss will be determined upon the basis of the value of the assets, including good will, if acquired prior to March 1, 1913, or their cost if acquired subsequent to that date.

The basis for deduction authorized under the provisions of article 174 is the return of capital on an asset, the use of which in the trade or business

is definitely limited in duration. The taxpayer did not elect, during the life of the patents acquired in 1902, to provide for this return of capital. Had he made this provision his surplus for invested capital purposes under the revenue act would have been correspondingly reduced.

He, therefore, cannot now claim in a high taxable year, after the expiration of the life of the patents, an amount equivalent to 1/17 of the cost, thereby securing the benefit not only of a reduction in his taxable income for the year 1917, but the advantage of the investment, which in value is subject only to the definite limitations prescribed by the act and the regulations.

The committee therefore sustains the action of the income-tax unit in disallowing the item of 50*x* dollars claimed by the taxpayer in the taxable year 1917, as a deduction based on 1/17 of the cost of said patents.

Section 301, article 711: Imposition of tax. (Also section 214 (a) 4, 5, 6, article 141.) A. R. M. 96

REVENUE ACT OF 1917

Held, that an individual who is engaged in more than one business, the income from which is taxable under different provisions of the law and regulations, may not deduct losses sustained in the one from gains or profits made in the conduct and operation of the other for the purpose of computing the excess profits tax for 1917.

The committee is in receipt of a memorandum from the income-tax unit in which the statement is made that the unit has consistently held that indivual taxpayers who suffered losses in 1917 from transactions which, had they resulted in a profit, would have been taxable under the provisions of section 201 of the revenue act of 1917, can not deduct such losses from income derived from a business in which there is no invested capital or not more than a nominal capital as provided in section 209 of the statute.

It is pointed out in the memorandum that cases arise in which losses are sustained in a business requiring the use of capital, and that such business may be closely related to the character of the business from which the individual taxpayer receives a salary or commissions which are taxable at the 8 per cent rate under the provisions of section 209. It is suggested that the ruling may be correct, but that it works a great hardship in many cases. Advice is requested as to whether the consistent action of the unit disallowing such losses for the purposes of the excess profits tax is correct.

It appears that A is a member of a partnership dealing on the Y exchange and that he receives for his services from such partnership a salary. In addition to the salary received for services rendered, it appears that A on his own account is engaged in the same general class of business as that of the partnership. A loss was sustained in such business and his representative strongly urges that since such loss was incurred in a business closely related to that in which the partnership was engaged he should be entitled to deduct such losses from the salary received, for the purpose of determining the income subject to tax at the 8 per cent rate under the provisions of section 209.

Section 200 of the revenue act of 1917 provides that when used in this title "the terms 'trade' and 'business' include professions and occupations."

Article 8 of regulations 41 reads as follows:

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.

Article 14 of regulations 41, as amended by treasury decision 3017, reads in part 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 section 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.)

Article 35 of regulations 41 deals with the determination of net income of individuals where there is no invested capital or not more than a nominal capital, and provides as follows:

The net income which is derived from a trade or business having no invested capital or not more than a nominal capital, including salaries, wages, fees, or other compensations (constituting net income of class A as defined in article 14) shall be determined for the taxable year by adding the total net income from all such sources (or in the case of a nonresident alien in-

dividual the total net income from all such sources within the United States) as reported for income tax purposes for the same year.

The inquiry here presented for consideration is whether an individual taxpayer engaged in two businesses: (1) Requiring invested capital and (2) requiring no invested capital or not more than a nominal capital, may deduct losses sustained in either from profits derived from the other. It has been consistently held that an individual may be engaged in more than one business, and even though such businesses may be closely related the losses in one may not be deducted from the profits of the other unless both businesses are taxable under the same provisions of the law.

In the instant case submitted with request for advice, it appears that A was engaged in two businesses during 1917; that these businesses may have been closely related and that from one he received a salary and from the other, in which he was trading on his own account with capital, he sustained a considerable loss. If he had shown a profit from both businesses there can be no question but that the income-tax unit would not have permitted the consolidation of such profits for the purpose of computing the tax, for the reason that the income derived from one business was clearly taxable under the provisions of section 209, and had there been income from the other business it would have clearly been taxable under the provisions of section 201. This being true, there is no sound argument why the losses sustained in business by A trading on his own account with capital may be deducted from the salary received for services rendered to a partnership of which he was a member.

In a prior committee recommendation it was held that a member of a banking firm was subject to excess-profits taxes on certain commissions received in 1917 from the sale of certain coal properties which were owned by a corporation of which the member of the firm owned a considerable part of the capital stock. It was there held that the commissions grew out of a transaction which was made possible through his banking connections and through his ownership of stock in the coal company. Had the amount received been profits on the sale of something which the individual member of the banking firm owned, such profits would not have been subject to the excess-profits tax under the provisions of section 209 but would have been subject to such tax under the provisions of section 201, provided the member of the banking firm devoted sufficient time and attention to the deal to constitute a trade or business.

Under the foregoing quoted provisions of the regulations the committee finds that A is engaged in two businesses: (1) As a member of a partnership from which he received a salary and (2) trading on the Y exchange on his own account with capital out of which the losses in question arose. If under the law and regulations the income from both businesses could not be combined for the purpose of computing excess-profits tax, it is thought that since there was a loss in one of the businesses in which the taxpayer was engaged, such loss may not properly be deducted from income clearly taxable under the provisions of a separate and distinct section of the statute.