Journal of Accountancy

Volume 32 | Issue 2 Article 7

8-1921

Income-tax Department

Stephen G. Rusk

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EDITED BY STEPHEN G. RUSK

The decision of the United District Court for the Eastern District of Missouri in the case of *Holbrook v. Moore,* in view of all the facts recited seems to be logical and just. The decision is somewhat similar to that given in the case of *Jackson v. Smietanka* (Treasury decision 3159, published in the June issue of THE JOURNAL OF ACCOUNTANCY). It involves a matter of additional salary being given an officer of a corporation for services rendered in a number of previous years, and the returning of the said additional compensation as taxable income in the year when actually determined. The taxpayer having overdrawn his account each year for a number of years and having been granted in 1918 a substantial portion of said overdraft as extra compensation sought to pro rate the additional amount as income over the years in which the services were rendered. This was denied to him and the total additional compensation was ruled to be taxable income in the year 1918.

Exempt corporations are treated of in treasury decision 3164. This decision sets out clearly that which the regulations have as clearly indicated, that a corporation organized for profit, though its activities be that of an educational character, is not exempt from federal income and profits taxes.

It is interesting to note that in this case the taxpayer seeks to deduct from taxable income the cost of furniture and fixtures, buildings and "other necessary improvements." It seems strange, at this late day, that anyone should expect to deduct items of the kind named.

(T. D. 3161.)

Income tax—Act of October 3, 1913—Decision of court.

1. INCOME—ADDITIONAL SALARY OF OFFICER OF CORPORATION, SUBSEQUENTLY AUTHORIZED, OFFSET BY OVERDRAFTS ALREADY MADE.

Where, relying on the unofficial promises of a majority of the board of directors that additional salary would be voted him for past years, the president of a corporation overdrew his account with the corporation, additional salary, subsequently voted, was income to him for the year in which the amount thereof was finally settled upon and segregated by an order of the board, although he had actually received and spent the money, as overdrafts, prior to that year.

2. SAME—INVALIDITY OF VOTE OF ADDITIONAL SALARY—ESTOPPEL BY INCOME-TAX RETURN.

Where the corporation deducted the additional salary of the president when it made its income-tax return, the validity of the order of the board granting such additional salary can not be questioned, although such president's vote as director of the corporation was necessary to pass the order, and the minority directors and the stockholders have never acquiesced therein.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To collectors of internal revenue and others concerned:

The appended decision of the United States district court for the eastern district of Missouri, dated February 8, 1921, in the case of *W. J. Holbrook v. George H. Moore,* collector, is published for the information of internal-revenue officers and others concerned.

M. F. WEST,
Acting Commissioner of Internal Revenue.

Approved May 3, 1921:

A. W. MELLON,
Secretary of the Treasury.

UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF MISSOURI.

No. 5161.

W. J. Holbrook, plaintiff, v. George H. Moore, collector, defendant.

Submitted to the court sitting as jury, on an agreed statement of facts.

[Decided Feb. 8, 1921.]

Oral opinion of the court: This case was submitted to the court sitting as a jury, and a jury being specially waived in writing, the court heard the testimony and the arguments of counsel, and has since considered the briefs filed on both sides.

The facts are somewhat unique, and I confess just a little difficulty with the case. Plaintiff is president of a real-estate company doing business here in the city of St. Louis. He is also, of course, a director in that company. He and two others of the directors (of whom there are five in all) made the orders and passed the resolutions to which I shall hereafter refer. The remaining two directors had nothing to do with these orders and resolutions.

Plaintiff and the two directors having to do with the resolution that I shall mention owned 75 per cent. of the capital stock; 25 per cent. is in the hands of other stockholders, presumably in the hands, among others, of the two directors not taking part in the orders and resolutions to which I have before referred.

In the years preceding March 1, 1913, the date at which the income-tax act took effect, that is, the act of October 3, 1913, plaintiff was the active manager of the corporation of which he is director and president. The affairs of his corporation seem to have been very successful and profitable. It was deemed by plaintiff and two of the directors that his services for the years 1909, 1910, 1911, and 1912 were such as reasonably to entitle him to additional compensation to that allowed him by the rules and by-laws of the board of directors. No agreement as to the amount of that compensation was ever arrived at by anybody up until December, 1913.

Plaintiff relying, as he says, upon the promise of two directors, became indebted to the company, and this indebtedness was carried on the books of the company as overdrafts. These overdrafts of plaintiff amounted in December, 1913, to about $70,000. In this month and year (plaintiff and two other directors concurring) plaintiff was allowed a credit upon the books of the company for $50,000, leaving the plaintiff owing the company at that time $20,000 on his overdrafts. Although seven years have passed, neither the other two directors, nor the stockholders, have ever affirmatively acquiesced in this allowance, although plaintiff was given credit for it upon the books of the company in December, 1913, in the sum that I have heretofore stated—$50,000.

In the year 1913 the Holbrock-Blackwelder Real Estate Trust Co. (I believe this is the exact style of it) made out its return as it was required to do by the law then in force, as a basis of assessment against it of an income tax for the year 1913. It may have been, perhaps, in January, 1914, but that cuts no figure in the case. In this return it took credit for the $50,000 that it had allowed to plaintiff on its books, as an expense. It is

true that it happened, fortuitously, that the company during the year 1913 had lost $76,000, so that it had to pay no income tax at all. It would not have had to pay it in any event.

Upon this $50,000 so carried to the credit of plaintiff upon the books of his company in 1913, the defendant assessed against him an income tax amounting to, I believe, $990.36. This tax the plaintiff paid. After the usual procedure, he brought suit against the defendant, Moore, in order to secure a refund. The question is whether this tax was correctly or incorrectly assessed against him under the law then in force. I have reached the conclusion that it was.

Up until December, 1913, and on the 28th of the month, I believe, there had never been an ascertainment of the amount that plaintiff should have from the company as additional compensation; that matter was left undetermined. It is true that he had gotten the money and had spent it in the years preceding the taking effect of the income-tax act of October, 1913. Upon the books of the company he owed it overdrafts not only for the $50,000, but for an amount largely in excess of that sum. Up to that time he had never gotten it and it was not certain that he ever would get it. But at this time the credit to come to him was finally settled upon and segregated by an order of the board. It may be said, since only two members of the board (in addition to plaintiff himself) acquiesced in this, that therefore it was no order, and that since the other two directors and the stockholders have never to this good day acquiesced in it, that it was no order. I take it, that the company is foreclosed by the fact that they took credit for it when they made their income-tax return for the year following the year at which they passed this credit to plaintiff upon the corporation's books.

I am led to the conclusion that I have reached largely by the case of *Jackson v. Smietanka* (267 Fed., 932), a case recently decided in Illinois, wherein the facts were that Jackson, as receiver for some railroad company, was allowed by order of the court, $2,000 per month for a number of years prior to the taking effect of the income-tax act of 1918. When a final settlement came Jackson as receiver was allowed $100,000 additional for his services, over and beyond the $2,000 a month that he had been collecting theretofore. It was understood throughout the receivership that when the same was finally settled he was to be allowed additional compensation. The order of the court allowing that additional compensation proportioned that allowance over the years 1914, 1915, 1916, and 1917, in practically equal amounts. Of course, Jackson contemplated paying an income tax; he conceded that, but the question the court had before it was whether Jackson ought to pay according to the law of 1918, or whether he ought to pay according to the law that was in force in 1914, 1915, and so on. The court held that he ought to pay as of the time, and under the law in force at the time the final settlement and final allowance was made.

This Jackson case is the one that I find nearest to the facts in this case. As I stated in the beginning, the case is a close and difficult one, but I have concluded, both upon the reasoning and under the authority of the Jackson case, that the judgment should be for the defendant. It is so ordered.

(T. D. 3164.)

Income tax—Revenue act of 1918—Decision of court.

1. EXEMPT CORPORATIONS—EDUCATIONAL INSTITUTIONS, WHERE PROFITS INURE TO PRIVATE STOCKHOLDERS.

A corporation organized for the purpose of conducting a military school for profit, the stock of which is owned entirely by the officers, directors, and teachers of the institution, is not exempt from income tax as an educational institution, no part of the net earnings of which inures to the benefit of any private stockholder or individual, within the meaning of subdivision 6, section 231, revenue act of 1918.

2. PRIVATE STOCKHOLDERS OR INDIVIDUALS—OFFICERS, DIRECTORS, AND TEACHERS OF MILITARY SCHOOL.

The term "private" is not used in the statute in contradistinction to "official," whether the latter be used in a military or an institutional sense, but as the antonym of "public," the supposed beneficiary of the benevolent activities of an institution devoted exclusively to public betterment; private pecuniary profit and gain is the test to be applied, and the officers, directors, and teachers of a military school corporation, owning the stock thereof, are "private stockholders" within the meaning of the act.

3. DEDUCTIONS—FAILURE TO APPEAL TO COMMISSIONER OF INTERNAL REVENUE.

A taxpayer can not claim a deduction in court for the first time, where, in its claim for refund filed precedent to bringing suit, it did not claim the right to such deduction or assert that it had failed to take it in computing net income in its return, or that it had failed to take credit for it, and where, consequently, a claim for the deduction was never presented to the commissioner of internal revenue for his decision.

4. DEDUCTIONS—EXPENSES—CAPITAL INVESTMENTS—COST OF NEW BUILDINGS.

No deduction as expenses is allowed by the law in any case in respect of any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property or estate.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To collectors of internal revenue and others concerned:

The appended decision of the district court of the United States for the western district of Missouri, dated March 23, 1921, in the case of *The Kemper Military School v. George F. Crutchley, collector,* is published for the information of internal revenue officers and others concerned.

M. F. WEST,
Acting Commissioner of Internal Revenue.

Approved May 11, 1921:

A. W. MELLON,
Secretary of the Treasury.

DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DIVISION OF THE WESTERN DISTRICT OF MISSOURI.

The Kemper Military School, plaintiff, v. George F. Crutchley, defendant.

[Decided Mar. 23, 1921.]

MEMORANDUM OF FINAL HEARING.

VAN VALKENBURGH, Judge: The plaintiff in this action seeks to recover the sum of $52,166.81 income taxes, with interest and penalty, alleged to have been illegally exacted from the plaintiff by the defendant for the year 1918. The basis of plaintiff's alleged right to recover the above sum is that it is exempt from tax as an educational institution, which was organized and operated exclusively for educational purposes, and that no part of its net earnings inures to the benefit of any private stockholder or individual. This defense is asserted under the following exemptions specifically provided by the congress:

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.

The plaintiff was incorporated June 15, 1909, under the provisions of chapter 12, article 9, of the revised statutes of Missouri, 1899, governing the formation of private corporations for manufacturing and business purposes. This statute appears as article 7 of chapter 33 of the revised statutes of 1909, concerning private corporations, and deals with corporations organized for pecuniary profit and gain. Plaintiff was not organized under the article of the same chapter, which deals with benevolent, religious, scientific, educational, and miscellaneous associations not intended for pecuniary gain or profit.

The school was originally of individual ownership. For many years prior to its incorporation it was owned by Col. T. A. Johnston, now its president and principal stockholder. He purchased it originally for approximately $12,000; since which time large additions and betterments have been made until its present total assets are shown to be $348,796.01, its liabilities $96,522.88, and its net resources $252,273.13. Its present attendance totals about 435 pupils. In 1918 and 1919, during war activities, it had a few over 500. In 1918 the charge was $600 per pupil for tuition, board, and lights. The charge now has been raised to $700. In addition thereto it sells to the pupils uniforms and books, upon which it makes a profit.

It receives minor items of income from other sources which do not require detailed consideration.

For the calendar year 1918 its gross income amounted to $205,153.26, of which the sum of $5,083.11 was received from sources other than tuition; after making statutory deductions the net income remaining amounted to $79,788.01. The figures involved are not in dispute except as to some claims for deduction to which reference will be hereafter made.

When the school was incorporated Colonel Johnston transferred the property to the corporation, receiving stock therefor. The remaining shares of stock were subscribed for by teachers, and the officers and board of directors are made up of such. These teachers paid for their stock out of their earnings. A dividend of 6 per cent. has been paid upon all stock since the date of the incorporation.

That the corporation is operated exclusively for educational purposes may be conceded. If the law had stopped there and had evidenced the purpose of exempting all such, the contention of the government would be without merit, but the law further provides that, not only must the corporation be organized and operated exclusively for educational purposes, but that no part of its net earnings should inure to the benefit of any private stockholder or individual. The case of *State ex rel J. L. Sillers v. Johnston* (214 Mo., 656), in which this same school was under discussion, is not in point. There the school was exempt under a provision of the state constitution and statute which exempts from taxation real estate "used exclusively for schools." The element of private pecuniary gain was not involved; and, furthermore, the construction of a state court upon a state constitution or law could not affect a federal statute of different intendment and uncontrolled by state laws.

This corporation, while devoted to educational purposes, was confessedly organized for private pecuniary profit and gain. Its teachers all receive salaries. In addition thereto, they have all, including Colonel Johnston, received an annual dividend of 6 per cent. upon their stock since the date the corporation was organized. While under the terms of the statute we are concerned chiefly with net earnings, nevertheless it may appropriately be remarked that the increase in value of the school property inures to the stockholders of this business corporation. It might at any time be sold and the purchase price divided proportionately to such holdings. Upon ultimate dissolution the holders of these shares of stock would receive the proceeds of the property, including accumulated income.

The chief insistence is that because all the shareholders are officers, directors, and teachers in the institution they are not "private stockholders

or individuals." This involves a narrowness of definition that can not be entertained in view of the obvious purpose and spirit of the act. The distinction is not between private and official, whether the latter be used in a military or an institutional sense. The word "private" as here used is the antonym of "public"—a private stockholder as distinguished from the general public—the supposedly beneficiary of the benevolent activities of an institution devoted exclusively to public betterment. Private pecuniary profit and gain is the test to be applied. This corporation was, and is, undeniably organized and operated for that purpose.

It does not detract, even in small degree, from the merit and worthy service of the plaintiff, as a valuable institution of learning, to hold, as we must, that it is not exempt from the tax imposed.

Plaintiff further contends that—

Even if it were liable to pay said taxes, they should not be collected for the year 1918 because it expended in the necessary furniture and fixtures the sum of $13,086.68 and for buildings and other necessary improvement $81,188.35, amounting in the aggregate to $94,275.03, which amount was expended for the upkeep and expansion of the plaintiff's plant and for the comforts and necessities of said school.

To this claim the defendant answers that plaintiff, in its appeal to the commissioner of internal revenue in its claim for the abatement of said taxes and for refund, never at any time asserted or claimed that it had failed to take credit for any deduction in its said return of income for the year 1918, which it was entitled to take, in computing its net income for that year, under the act of congress, and that said claim was never at any time presented by the plaintiff to the commissioner of internal revenue for his consideration and decision thereon; further, that in computing its net income for the year 1918 plaintiff deducted, in its said return of income for said year, a reasonable allowance for the exhaustion, wear, and tear of the property used in its trade or business, including a reasonable allowance for obsolescence. These allegations of the answer are sustained by the testimony. The law provides for a reasonable allowance for exhaustion, wear and tear, etc., as conceded by defendant, and as claimed by plaintiff in its return and allowed by the collector and commissioner. It further provides that in computing net income no deduction shall in any case be allowed in respect of any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property or estate. It follows that this claim for deduction, in the sum of $94,275.03, or any part thereof, can not be indulged.

It appearing that the grounds upon which plaintiff relies for recovery are untenable, and there being no dispute that the amount of the tax levied was correct, if plaintiff's contentions are not sustained, it follows that judgment must be entered for the defendant, and it is so ordered.

Howard F. Farrington announces the opening of offices in the Woolworth building, Watertown, New York.

Arthur Anderson announces the opening of an office in the National City building, 42nd street and Madison avenue, New York.

Mackay, Irons & Co. announce the removal of their office to 165 Broadway, New York, and the admission to partnership of Douglas H. Strachan.

Clinton H. Montgomery & Co. announce the removal of their offices to 1100-1107 Bitting building, Wichita, Kansas, and the opening of an office at 229 Frisco building, Joplin, Missouri.