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Income-tax Department

Stephen G. Rusk

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Income-tax Department

EDITED BY STEPHEN G. RUSK

There have been many treasury decisions accumulated since the last issue of THE JOURNAL OF ACCOUNTANCY, and the subject matter is so varied and interesting that we recommend for them a careful reading. Because of the number and the amount of space that the publication of these decisions will occupy we refrain from comment thereon, except to point out a few of special interest.

Treasury decision No. 3050 is especially interesting, and should have careful consideration by accountants in states that have enacted inheritance-tax laws, for it sets forth succinctly why inheritance taxes are not deductible in computing federal income taxes.

Stock dividends, as distinguished from cash dividends, are the subject matter of treasury decision No. 3052.

Rules are laid down in treasury decision 3058 for the inventorying of merchandise by dry-goods dealers.

The above-mentioned decisions, together with those treating of depletion of combined oil and gas wells and various other matters, will be found well worth a few hours' time of any one whose opinion is sought upon income-tax matters.

(T. D. 3047, July 24, 1920)

Income tax

Section 203, revenue act of 1918—Inventories at market—Regulations No. 45 amended

Article 1584, regulations No. 45, is hereby amended to read as follows:

ART. 1584. *Inventories at market*—Market means the current bid price prevailing at the date of the inventory for the particular merchandise, and is applicable to goods purchased and on hand and to basic materials in goods in process of manufacture and in finished goods on hand, exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts at fixed prices entered into before the date of the inventory, *which goods must be inventoried at cost.* Where no open-market quotations are available the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available to him, such as specific transactions in reasonable volume entered into in good faith, or compensation paid for cancellation of contracts for purchase commitments. The burden of proof will rest upon the taxpayer in each case to satisfy the commissioner of the correctness of the prices adopted. It is recognized that in the latter part of 1918, by reason among other things of governmental control not having been relinquished, conditions were abnormal and in many commodities there was no such scale of trading as to establish a free market. In such a case, when a market has been established during the succeeding year, a claim may be filed for any loss sustained in accordance with the provisions of section 214 (*a*) (12) or section 234 (*a*) (14) of the statute. See articles 261-268.

(T. D. 3048, July 26, 1920)

Income tax—Decision of court

Interest which accrued prior to 1909 and was paid in 1911 was not income within the provisions of the excise tax law of 1909.

The appended decision of the United States district court of Minnesota, handed down in March, 1920, in the case of *Northern Pacific Railway Co., plaintiff, v. Lynch, collector,* is published for the information of internal revenue officers and others concerned.

District court of the United States of the district of Minnesota. No. 1005 Northern Pacific Railway Co., plaintiff, v. Edward J. Lynch, collector of internal revenue, defendant

Pursuant to stipulation of the parties waiving a jury duly filed, this case comes on for hearing before the undersigned without a jury at St. Paul on the 22d day of March, 1920, Charles W. Bunn appearing for the plaintiff and Alfred Jaques for the defendant.

The court, having heard the parties, finds as facts:

1. The item, interest on advances to Spokane, Portland & Seattle Railway Co. ($1,603,707.50), was interest accrued before January 1, 1909, on advances which the plaintiff made for construction of the railway of the Spokane, Portland & Seattle Railway Co. This railway was a joint enterprise of the plaintiff and the Great Northern Railway Co., and its construction was provided for in an agreement between the Northern Pacific Railway Co. and the Great Northern Railway Co., made on the 1st day of January, 1908, and a further agreement contemporaneously made between the said two railway companies and the Spokane, Portland & Seattle Railway Co., dated on the same day. It was specially agreed in said contracts that advances of money made by either the Northern Pacific Railway Co. or Great Northern Railway Co. for carrying on the said joint enterprise should be repaid with interest at the rate of 5 per cent per annum from the time of making each advance. These advances commenced on or about the date of said contracts and continued until some time in the year 1911. The interest accruing on the advances was not entered up either on plaintiff's books or of those of the Spokane, Portland & Seattle Railway Co. until the construction work was completed in 1911, when the advances made by the Northern Pacific Railway Co. with interest were repaid by the Spokane, Portland & Seattle Railway Co. according to the terms of said contract. The item of interest in question is the amount of interest which accrued on said advances prior to the 1st of January, 1909, and which was settled and paid in the year 1911.

2. The plaintiff on the trial abandoned the claim made in the complaint on account of the item of $263.18.

3. The other item included in this suit was definitely ascertained and vested in the plaintiff before the 1st day of January, 1909, and were on that day the property of the plaintiff.

The court directs judgment in favor of the plaintiff against the defendant in the sum of $16,040.98, together with interest at the rate of 6 per cent from the 12th day of September, 1917, the date of plaintiff's payment to defendant under protest.

(T. D. 3049, July 27, 1920)

Income tax—Compensation of federal judges—Opinion of the attorney general

The compensation of a judge of the supreme court or of an inferior court of the United States is subject to a statute imposing an income tax enacted before his term of office begins.

Income-tax Department

In the case of *Evans v. Gore* (T. D. 3037 of June 21, 1920), the supreme court held that salaries of federal judges, appointed before the incidence of the revenue act of 1918, are not subject to payment of income tax thereunder. The attorney general, in response to a request from the secretary of the treasury, has advised that the salary of a federal judge may be subjected to a federal income tax where the act imposing such tax is passed prior to the time the judge in question took office. A copy of the opinion of the acting attorney general is published herewith for your information.

This office will be governed by the opinion of the acting attorney general.

DEPARTMENT OF JUSTICE

WASHINGTON, June 21, 1920.

DEAR MR. SECRETARY: I have the honor to acknowledge receipt of your request to be advised whether, in view of the supreme court's decision in the case of *Evans v. Gore,* to refrain from the collection of income taxes under the revenue act of 1918 from judges and the president taking office after the passage of the act, as well as from those in office when the law was passed.

In the opinion of the solicitor accompanying your request certain quotations are made from the opinion of the court in the case above referred to as indicating that the court intended to hold that the salary of no federal judge could constitutionally be included in his taxable income regardless of whether he became a judge before or after the passage of the act. I do not think, however, that anything that was said in that opinion can fairly bear this construction. That question was not before the court. The judge then contesting the constitutionality of the law was appointed many years ago, and the rights of one appointed subsequent to the enactment of the law were in nowise involved. The only question was whether the requirement that a judge's salary should be included in his taxable income was, within the meaning of the constitution, a diminution of his compensation as it had been fixed by act of congress prior to the enactment of this tax law. Congress has the same power to fix the compensation of judges that it has to levy taxes, except that it has no power during the term of office of a judge to fix his compensation at a sum less than it was when he became a judge.

The effect of the recent decision is to hold that the levying of a tax upon the compensation thus fixed is a diminution of that compensation in the constitutional sense. In fixing the compensation, however, which judges hereafter appointed shall receive, there is no limitation upon the power of congress. It may fix the compensation of such judges at a figure less than that now received by judges of the same rank, and which the latter will be entitled to receive during the remainder of their service. In fixing such compensation, I see no reason why congress may not say that the compensation shall be a certain amount less a fixed percentage thereof which shall be paid or retained as an income tax. When, therefore, after the salary of the judges has been fixed by law and another act has been passed making those salaries subject to a fixed and definite income tax, a judge who is appointed takes his office with his actual compensation fixed at the amount of the salary less the amount of income tax. Upon assuming the duties of the office he is entitled to receive no more than this; and when he pays the tax previously fixed by law there has been no diminution of the compensation to which he was entitled at the beginning of his term of service. I am unable to see, therefore, that there is anything in the recent opinion of the supreme court which relieves a judge appointed since the enactment of the income-tax law from paying the tax imposed by that law.

Respectfully,

WILLIAM L. FRIERSON,
Acting Attorney General.

HON. DAVID F. HOUSTON,
Secretary of the Treasury, Washington, D. C.

(T. D. 3050, July 27, 1920)

Income tax—Decision of court

Deductibility of New York inheritance tax in computing income of legatee.

The tax imposed by the state of New York on the transfer of decedent's estate is a tax on the right of disposition of the property, and is not a tax on the privilege of the legatee to receive it. Therefore in computing the net income of the legatee subject to the income tax the New York inheritance tax is not a proper deduction from gross income under the provisions of section 2, paragraph B, act of October 3, 1913.

The appended decision of the United States circuit court of appeals for the second district in the case of *Elizabeth S. Prentiss v. Mark Eisner, collector,* third district of New York, affirming the judgment of the lower court (260 Fed., 589, T. D. 2933), is published for the information of internal-revenue officers and others concerned.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

Elizabeth S. Prentiss, plaintiff in error (plaintiff below), v. Mark Eisner, collector of internal revenue, third district of New York, defendant in error (defendant below).

Before ROGERS, HOUGH and MANTON, circuit judges

This cause comes here on writ of error to the United States district court for the southern district of New York.

The facts are stated in the opinion.

ROGERS, circuit judge: This is an action to recover from the defendant the sum of $7,432.88 with interest, which amount the plaintiff alleges she was wrongfully compelled to pay to the defendant as collector of internal revenue.

It appears that the plaintiff and her then husband, since deceased, filed with the defendant a joint return of their net income for the year 1913, pursuant to the act of congress approved October 3, 1913 (U. S. Stat. L., vol. 38, pt. 1, ch. 16, Sec. II, p. 166).

The aforesaid act of congress, in paragraph B, page 167, provided as follows:

That, subject only to such exemptions and deductions as hereinafter allowed, the net income of a taxable person shall include gains, profits and income, including * * * but not the value of property acquired by gift, bequest, devise, or descent. * * *

That in computing the net income for the purpose of the normal taxes there shall be allowed as payment; * * * third, all national, state, county, school and municipal taxes paid within the year, not including those assessed against local benefits.

And in paragraph D, page 168, it provided as follows:

The said tax shall be computed upon the remainder of said net income of each person subject thereto accruing during each preceding calendar year ending December thirty-first: *provided, however,* That for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen, both dates inclusive, after deducting five-sixths only of the specific exemptions and deductions herein provided for.

It appears, too, that in the year 1913 the plaintiff inherited a portion of her father's estate, and that on the inheritance thus received by her the state of New York assessed against her an inheritance tax of $259,805.71, which amount she paid on December 11, 1913.

The plaintiff in making her income return under the act of congress included therein as a deduction five-sixths of the inheritance tax which she had

paid to the state of New York, which amounted to $216,504.75. This deduction was not allowed by the commissioner of internal revenue, and he levied and assessed against her an additional tax of $7,432.88. Thereupon she instituted this action to recover back the amount so paid.

The complaint was demurred to upon the ground that it did not state facts sufficient to constitute a cause of action. The court below sustained the demurrer and dismissed the complaint.

The question of law thus presented is whether the payment by the plaintiff of the inheritance tax to the state of New York was a proper deduction from her income tax return for the year 1913. That is the sole question herein involved. The plaintiff's contention is that the inheritance tax which she paid to the state of New York was a tax paid to a state, and therefore under the act of congress the plaintiff was entitled to make the deduction of five-sixths of the amount so paid in making her income return.

The commissioner of internal revenue in making the ruling to which reference has been made stated that—

A collateral inheritance tax levied under the laws of the state of New York being, as it is, a charge against the corpus of the estate, does not constitute such an item as can be allowed as a deduction in computing income tax liability to either the estate or beneficiary thereof.

The district judge in sustaining the demurrer states that he did not regard the New York transfer tax "as imposing a tax upon the plaintiff's right of succession which is deductible in her income tax return."

Material provisions of the New York transfer tax act may be found in the margin.

The New York act reads as follows in section 220 of Article X:

A tax shall be and is hereby imposed upon the transfer of * * * property * * * to persons or corporations in the following cases * * * : (1) When the transfer is by will or by the interstate laws of this state * * * (4) when the transfer is by deed * * * intended to take effect in possession or enjoyment at or after such death. * * * The tax imposed hereby shall be upon the clear market value of such property at the rates hereinafter prescribed.

Section 224 reads as follows:

Lien of tax and collection by executors, administrators and trustees.—Every such tax shall be and remain a lien upon the property transferred until paid, and the person to whom the property is so transferred, and the executors, administrators, and trustees of every estate so transferred shall be personally liable for such tax until its payment. Every executor, administrator or trustee shall have full power to sell so much of the property of the decedent as will enable him to pay such tax in the same manner as he might be entitled by law to do for the payment of the debts of the testator or intestate. Any such executor, administrator or trustee having in charge or in trust any legacy or property for distribution subject to such tax shall deduct the tax therefrom and shall pay over the same to the state comptroller or county treasurer, as herein provided. If such legacy or property be not in money, he shall collect the tax thereon upon the appraised value thereof from the person entitled thereto. He shall not deliver or be compelled to deliver any specific legacy or property subject to tax under this article to any person until he shall have collected the tax thereon. If any such legacy shall be charged upon or payable out of real property, the heir or devisee shall deduct such tax therefrom and pay it to the executor, administrator or trustee, and the tax shall remain a lien or charge on such real property until paid; and the payment thereof shall be enforced by the executor, administrator or trustee, in the same manner that payment of the legacy might be enforced, or by the district attorney under section two hundred and thirty-five of this

chapter. If any such legacy shall be given in money to any such person for a limited period, the executor, administrator or trustee shall retain the tax upon the whole amount, but if it be not in money, he shall make application to the court having jurisdiction of an accounting by him, to make an apportionment, if the case require it, of the sum to be paid into his hands by such legatee, and for such further order relative thereto as the case may require.

The right to dispose of property by will is statutory. The matter has always been recognized as within the legislative control. In the reign of Henry II (1154-1189) a man's personal property was, at his death, divided into three equal parts, if he died leaving a wife and children: One part went to his wife, another to his children, and only the remaining third could be disposed of by his will. And, at least after the establishment of the feudal system and prior to the enactment of the statute of wills (32 Henry VIII), the right to make a will of real estate was not known to the English law.

There has been and still is a difference of opinion among the courts as to the exact nature of an inheritance tax. It is generally agreed that such a tax is not upon the property or money bequeathed. The dispute is over the question whether the tax is laid on the privilege of receiving the property so transmitted. The right to transmit and the right to receive are distinct, and each is alike under the legislative control. The distinction between the right to transmit and the right to receive is important, and upon the distinction depends the right to deduct or not to deduct the amount of the tax in the income return submitted to the federal government.

The circuit court of appeals in the third circuit has recently decided *Lederer v. Northern Trust Co.* (262 Fed., 52). In that case the question arose as to the right to deduct a tax paid under the collateral inheritance tax act in the state of Pennsylvania. The answer to be given to that question depended upon whether the Pennsylvania tax was an estate tax, the burden of which was imposed upon the estate of a decedent as claimed by the executors, or was a legacy tax, the burden of which was imposed upon the legatee or beneficiary. It happened that the supreme court of Pennsylvania in *Jackson v. Myers* (257 Pa., 104) had squarely decided that the collateral inheritance tax of that state was not levied upon an inheritance or legacy, but upon the estate of the decedent, and had held that what passed to the legatee was simply the portion of the estate remaining after the state had been satisfied by receiving the tax. The circuit court of appeals held that the decision of the supreme court of Pennsylvania construing the inheritance tax law of that state was binding on the federal courts, and that inasmuch as the tax was held by that court as a tax on the estate and not a tax on the inheritance, the amount of the tax so paid was properly deductible in computing the net estate under the act of congress of September 8, 1916. Under a like state of facts we should have no difficulty in reaching a like conclusion. But the case with which we are dealing presents a different question, involving, as it does, the tax law not of Pennsylvania but of New York.

In 1900 the supreme court in *Knowlton v. Moore* (178 U. S., 41) had under consideration a tax imposed under the war revenue act of June 13, 1898 (20 Stat., 448). The opinion in that case is exhaustive and occupies about 70 pages. It deals with the subject of death duties and sustains the constitutional right of congress to impose death duties. In the course of the opinion, which was written by Justice (now Chief Justice) White, it was said:

Thus, looking over the whole field, and considering death duties in the order in which we have reviewed them, that is, in the Roman and ancient law; in that of modern France, Germany and other continental countries; in England and those of her colonies where such laws have been enacted,

in the legislation of the United States and the several states of the Union—the following appears: Although different modes of assessing such duties prevail, and although they have different accidental names, such as probate duties, stamp duties, taxes on the transaction, or the act of passing of an estate or a succession, legacy taxes, estate taxes, or privilege taxes, nevertheless tax laws of this nature in all countries rest in their essence upon the principle that death is the generating source from which the particular taxing power takes its being, and that it is the power to transmit, or the transmission from the dead to the living, on which such taxes are more immediately rested.

It thus appears, as the opinion of the court, that in general death duties are imposed on the power to transmit. However, the immediate question with which we are now concerned is whether the so-called tax which the New York law has imposed, and which is herein involved, is a tax upon the power to transmit or is laid on the power to receive. In 1889 a testator within the state of New York died and devised and bequested all his estate,—both real and personal, to the government of the United States. The surrogate's court imposed an inheritance tax upon the personal property. The case was taken on appeal to the general term of the supreme court of New York and later to the New York court of appeals, by each of which it was affirmed. It was then taken to the supreme court of the United States, by which it was in like manner affirmed. The question was whether the personal property bequeathed to the United States was subject to an inheritance tax under the laws of New York. The supreme court held the property to be subject to the tax. (*United States v. Perkins,* 163 U. S., 625.) In the course of its opinion the court said: "In this view the so-called inheritance tax of the state of New York is in reality a limitation upon the power of a testator to bequeath his property to whom he pleased; a declaration that, in the exercise of that power, he shall contribute a certain percentage to the public use; in other words, that the right to dispose of his property by will shall remain, but subject to a condition that the state has a right to impose. Certainly, if it be true that the right of testamentary disposition is purely statutory, the state has a right to require a contribution to the public treasury before the bequest shall take effect. Thus the tax is not upon property, in the ordinary sense of the term, but upon the right to dispose of it, and it is not until it has yielded its contribution to the state that it becomes the property of the legatee." And the court went on to say: "That the tax is not a tax upon the property itself, but upon its transmission by will or by descent, is also held both in New York and in several other states." We find no case in the subsequent decisions of the New York court of appeals in which that court disclaims the construction placed by the supreme court of the United States on the New York decisions, or in any way qualifies or overrules the proposition that the "tax" under the New York law is not one upon the property, but is one upon the right to dispose of it by will or by descent. In the absence of such a decision it seems to be our duty to follow the law as it is laid down in the Perkins case unless there can be found in the New York statute in force, when the present tax was laid, some substantial difference from the statute in force when that case was decided in the particular now being considered. If such a difference exists we have failed to detect it, and learned counsel have failed to point out in what it consists.

The New York court of appeals in 1919 in matter of Watson, 226 N. Y., 384, 399, the court, in discussing a provision in the New York inheritance tax law imposing tax upon the transfer of property at the time of death which had not theretofore paid any tax, local or state, said: "The beneficiary has no claim to the property of an ancestor except as given by law, and, if the state has a right to impose a tax at all upon the passing of property, the transferee takes only what is left after the tax is paid." The opinion quotes

at page 396 from the opinion of the supreme court of the United States in the matter of Penfield, 216 N. Y., 163, 167 (1915), that under the New York law the inheritance tax is not upon the property but upon the right to dispose of it. There is not one word of criticism, not one word of dissent, and not the slightest suggestion of disapproval of that proposition anywhere in the opinion.

In matter of Penfield, supra, the New York court declares what it had several times before stated that "the transfer tax is not a tax upon property, but upon the right of succession to property." The language of the statute is that the tax is "due and payable at the time of the transfer"; that is, at the death of the decedent. It accrues at that time.

Now a succession tax is a tax upon a transfer of property in general, and as such is distinguishable from a legacy duty, which is a tax upon a specific bequest. Under the New York law the succession tax creates a lien upon the estate of the decedent at the moment of his death. The right of the state to the amount of this lien attaches at that time and it must be paid before the transferee, legatee or devisee ever gets anything, and the executor or administrator is personally liable for the tax until it has been paid. Under such a law we do not see that the transferee pays the tax. In stating this conclusion we have not overlooked what was said in the matter of Gihon, 169 N. Y., 443, 447, where it is said that "though the administrator or executor is required to pay the tax, he pays it out of the legacy for the legatee, not on account of the estate. The requirement of the statute that the executor or administrator shall make the payment is prescribed to secure such payment, because the government is unwilling to trust solely to the legatee." The fact, however, remains that if a legacy left by a will is $10,000, and the executor has paid to the state on its account a tax of $500, and then has turned over to the legatee $9,500, the legatee has received not $10,000 but $9,500, and the legatee has been enriched only to the extent of the amount which he has himself received, and he has not paid the tax nor has it been paid by his authority, nor by anyone representing him. The payment has been made by the personal representative of the deceased, and in making it he has acted under authority of the statute.

As was said by Judge Gray in matter of Swift, 137 N. Y., 77, "What has the state done, in effect, by the enactment of this tax law? It reaches out and appropriates for its use a portion of the property at the moment of its owner's decease; allowing only the balance to pass in the way directed by the testator, or permitted by its intestate law."

We admit that the New York cases on the subject of taxable transfers are confused and not always clear and consistent. But until the New York court of appeals authoritatively states that the law of New York is not what the supreme court of the United States said it was in the Perkins case, this court has no alternative but to hold that the New York transfer act does not impose a tax on a legatee's right of succession which is deductible in her income tax return. The legacy which the plaintiff herein received under the will of her father did not become her property until after it had suffered a diminution to the amount of the tax, and the tax that was paid thereon was not a tax paid out of the plaintiff's individual estate but was a payment out of the estate of her deceased father of that part of his estate which the state of New York had appropriated to itself, which payment was the condition precedent to the allowance by the State of the vesting of the remainder in the legatee.

Judgment affirmed.

(T. D. 3051, July 27, 1920)

War excess profits tax—Title II, act of October 3, 1917—Decision of Court

1. Invested Capital

The act of 1917 undertakes to define "invested capital," and in com-

puting invested capital it is necessary to come within the definition contained in the act.

2. INVESTED CAPITAL

   Appreciation of capital assets not realized by sale cannot be included in the computation of invested capital.

3. STATUTORY CONSTRUCTION

   Inequalities in a valid taxing act arising in the application to a particular case cannot be corrected by judicial construction.

4. STATUTORY CONSTRUCTION

   Where the act is ambiguous the construction of the administrative officers charged with its execution is entitled to great respect.

The appended memorandum decision of the United States court of claims in the case of *La Belle Iron Works, petitioner, v. the United States* is published for the information of internal revenue officers and others concerned.

NOTE:—In order that the opinion of the court in the case may be more clearly understood it may be desirable to state briefly the material facts, as set out in plaintiff's petition.

STATEMENT OF FACTS

Plaintiff is a West Virginia corporation. Prior to the year 1904 the corporation acquired certain ore lands, paying therefor the sum of $190,000. After the said ore lands were so acquired extensive explorations were carried on, and it was proved that said lands contained large bodies of ore. Between the date of purchase and the year 1912 the lands greatly increased in value. In the year 1912 the actual cash value of said lands was not less than $10,105,400, and at all times during the years 1912 to 1917 the actual value of the lands in question was not less than $10,105,400. In the year 1912 the corporation increased the valuation of said lands on its books by adding thereto the sum of $10,000,000, and carried such last-mentioned sum to surplus. Thereupon in said year 1912 the corporation declared a stock dividend in the sum of $9,115,400, representing the increase in value of said lands. At that time the old stock in the corporation was surrendered by the shareholders and new stock including the stock dividend was issued. In the year 1917 the petitioner included the sum representing the increased value of its lands in the computation of its invested capital for the purpose of determining the amount of its excess profits taxes. The commissioner refused to allow the corporation to include the said sum of $9,915,400 in computing its invested capital for the year 1917. Accordingly, said sum was stricken from the corporation's invested capital, which was thereby reduced from $26,322,907.14 to $16,407,507.14. The direct result of so reducing the invested capital of the corporation was an additional excess profits tax of $1,081,184.61, which was paid under protest. Claim for refund was duly rejected. Plaintiff thereupon brought the suit in question for the purpose of recovering said sum of $1,081,184.61, alleging it to have been unlawfuly collected.

Plaintiff alleged that the appreciated value of its ore lands was "tangible property paid in for stock"—that it was also "earned surplus used or employed in the business," and therefore came within the definition of invested capital in the revenue act of 1917. Plaintiff further contended that the construction given to the act by the government resulted in inequalities and was therefore erroneous.

The following is the order of the court dismissing the petition and memorandum therewith:

COURT OF CLAIMS OF THE UNITED STATES. No. 34603
(Decided June 28, 1920)

La Belle Iron Works, a corporation, v. United States

This cause coming on to be heard was submitted to the court—three judges sitting—upon the defendant's demurrer to the plaintiff's petition, as amended, and was argued by counsel. On consideration whereof, the court is of the opinion that the demurrer is well taken. It is therefore adjudged and ordered that the defendant's demurrer to the petition so amended in this cause be, and the same is hereby, sustained and the petition as amended is dismissed.

MEMORANDUM

The court's conclusions are:

(1) That the act in question (40 Stat., 306) undertakes to define "invested capital," and the averments of the petition cannot be said to bring the plaintiff's case within the definition of section 207.

(2) That the increase in value of plaintiff's ore lands, which was first declared to be surplus, and afterwards treated as the basis of a stock dividend, did not thereby become earned surplus or individual profits or invested capital within the meaning of the act of 1917. The stock dividend added nothing to, and took nothing from, the corporation's invested capital.

(3) That the inequalities, which can arise in the application of the statute to particular cases, cannot be corrected by judicial construction, where the enactment is otherwise valid.

(4) That where the act is ambiguous or uncertain, the construction of it by the administrative officers charged with its execution is entitled to great respect.

(T. D. 3052, August 4, 1920)

Income tax

Stock dividends—Some applications of the decision of the supreme court of the United States in the case of *Eisner v. Macomber,* rendered March 8, 1920, in the determination of the taxability of dividends.

The following applications of the decision of the supreme court of the United States in the case of *Eisner v. Macomber* in the determination of the taxability of dividends declared by corporations are published for the information and guidance of internal revenue officers and others concerned:

1. Where a corporation, being authorized so to do by the laws of the state in which it is incorporated, transfers a portion of its surplus to capital account, issues new stock representing the amount of the surplus so transferred, and distributes the stock so issued to its stockholders, such stock is not income to the stockholders, and the stockholders incur no liability for income tax by reason of its receipt.

2. Where a corporation, being thereunto lawfully authorized, increases its capital stock, and simultaneously declares a cash dividend equal in amount to the increase in its capital stock, and gives to its stockholders a real option either to keep the money for their own or to reinvest it in the new shares, such dividend is a cash dividend and is income to the stockholders whether they reinvest it in the new shares or not.

3. Where a corporation, which is not permitted under the laws of the state in which it is incorporated to issue a stock dividend, increases its capital stock, and at the same time declares a cash dividend under an agreement with the stockholders to reinvest the money so received in the new issue of capital stock, such dividend is subject to tax as income to the stockholder.

4. Where a corporation, having a surplus accumulated in part prior to

March 1, 1913, and being thereunto lawfully authorized, transfers to its capital account a portion of its surplus, issues new stock representing the amount so transferred to the capital account, and then declares a dividend payable in part in cash and in part in shares of the new issue of stock, that portion of the dividend paid in cash will, to the amount of the surplus accumulated since March 1, 1913, be deemed to have been paid out of such surplus, and be subject to tax, but the portion of the dividend paid in stock will not be subject to tax as income.

5. A dividend, paid in stock of another corporation held as a part of the assets of the corporation paying the dividend, is income to the stockholder at the time the same is made available for distribution to the full amount of the then market value of such stock (*Peabody v. Eisner,* 247 U. S., 347); and if such stock be subsequently sold by the stockholder, the difference between its market value at date of receipt and the price for which it is sold is additional income or loss to him, as the case may be.

6. The profit derived by a stockholder upon the sale of stock received as a dividend is income to the stockholder, and taxable as such even though the stock itself was not income at the time of its receipt by the stockholder. For the purpose of determining the amount of gain or loss derived from the sale of stock received as a dividend, or of the stock with respect to which such dividend was paid, the cost of each share of stock (provided both the dividend stock and the stock with respect to which it is issued have the same rights and preferences) is the quotient of the cost of the old stock (or its fair market value as of March 1, 1913, if acquired prior to that date), divided by the total number of shares of the old and new stock.

(T. D. 3053, August 10, 1920)

Income tax

Gross income of life insurance companies—Article 549 of regulations No. 45, amended

Article 549 of regulations No. 45 is hereby amended to read as follows:

ART. 549. Gross income of life insurance companies.—A life insurance company shall not include in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year. (*a*) "Paid back" means paid in cash. (*b*) "Credited to" means applied by way of credit to the payment of the premium for the taxable year. It does not include dividends applied to purchase additional paid-up insurance or annuities, or to shorten the endowment or premium paying period, or in any way that does not actually reduce the premium receipts of the company for the taxable year. (*c*) "Treated as an abatement of premium" means of the premium for the taxable year. Where the dividend paid back is in excess of the premium received from the policyholder within the taxable year there may be excluded from gross income only the amount of such premium received, and where no premium is received from the policyholder within the taxable year the company is not entitled to exclude from its premiums received from other policyholders any amount in respect of such dividend payment.

(T. D. 3055, August 12, 1920)

Income tax

Computation of depletion allowance for combined holdings of oil and gas wells—Article 214, regulations No. 45, amended. Article 214 of regulations No. 45 is hereby amended to read as follows:

ART. 214. *Computation of depletion allowance for combined holdings of oil and gas wells.*—(1) The recoverable oil belonging to the taxpayer shall be

estimated for each property separately. The capital account for each property shall include the cost of value, as the case may be, of the oil or gas lease or rights, plus all incidental costs or development not charged as expense nor returnable through depreciation. The unit value of the recoverable oil or gas for each property is the quotient obtained by dividing the capital account recoverable through depletion for each property by the estimated number of units of recoverable oil or gas on that property. This unit for each separate property multiplied by the number of units of oil or gas produced within the year by the taxpayer upon such property will determine the amount which may be deducted for depletion from the gross income of that year for that property. The total allowance for depletion of all the oil or gas properties of the taxpayer will be the sum of the amounts computed for each property separately: provided,

(2) That in the case of gas properties the depletion allowance for each pool may be computed by using the combined capital accounts returnable through depletion of all the tracts of gas land owned by the taxpayer in the pool and the average decline in rock pressure of all the taxpayer's wells in such pool in the formula given in article 211. The total allowance for depletion in the gas properties of the taxpayer will be the sum of the amounts computed for each pool.

(T. D. 3056, August 14, 1920)

Income tax

Concerning the creation of a sinking fund by a corporation in order to secure the payment of its bonds or other indebtedness

The final edition of regulations No. 45 is amended by inserting immediately after article 541 a paragraph, to be known as article 541 (*a*), as follows:

ART. 541 (*a*). *Creation of sinking fund.*—If a corporation, in order solely to secure the payment of its bonds or other indebtedness, places property in trust, or sets aside certain amounts in a sinking fund under the control of a trustee, who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and shall be included as such in its annual return. The trustee, however, is not taxable as such on account of the property or fund so held. (See sec. 219 and arts. 341 to 347.) If such fund is invested by the trustee in whole or in part in bonds, the trustee when presenting coupons from the bonds for payment shall file ownership certificates (form 1001 revised), whether or not the bonds contain a tax-free covenant clause. (See art. 366.)

(T. D. 3057)

Corporation excise tax—Act of August 5, 1909—Decision of court

1. MUTUAL LIFE INSURANCE COMPANY—INCOME RECEIVED DURING THE YEAR—SURPLUS—DIVIDENDS

In the case of a mutual life insurance company, transacting business on the level-premium plan, the surplus out of which dividends are paid in any year consists of the ascertained over-payments of premiums for the preceding year. Therefore, surplus for the year 1909 was received prior to the time the act became effective, and dividends paid out of such surplus and applied, at the option of the policyholder, to purchase paid-up additions and annuities or in partial payment of renewal premiums, were not income for the year in which they were applied. The surplus from premiums out of which the dividends for the year 1910 were declared was a part of the income for the

1909, and formed a basis for taxation for that year. *Maryland Casualty Co. v. United States,* 251 U. S., 342, distinguished.

2. Deferred Premiums—Accrued Interest—Income When Received

Premiums due and deferred and interest due and accrued but not actually collected in cash within the taxable year are not income "received."

3. Interest on Policy Loans—Income When Paid

Interest on policy loans, which by the terms of the contract was added to the principal when it became due, does not constitute income where it remains unpaid by the policyholder.

4. Deductions—Amortization of Bonds—Depreciation

Decrease in the value of assets of an insurance company through amortization of premiums on bonds are mere book adjustments and are not deductible as an item of depreciation.

5. Deductions—Net Addition to Reserve—Definition

The reserve funds, the net addition to which is to be deducted from the gross income of a life insurance company in computing its net income, are those funds which are built up to mature the policy, and do not include funds reserved, because of liabilities on supplementary contracts not involving life contingencies and canceled policies upon which a cash-surrender value may be demanded.

6. Judgment Modified

The judgment of the district court (248 Fed., 568) modified.

The appended decision of the United States circuit court of appeals for the seventh circuit in the case of *Henry Fink, collector, etc., v. Northwestern Mutual Life Insurance Co.,* is published for the information of internal revenue officers and others concerned.

United States Circuit Court of Appeals for the Seventh Circuit.
No. 2675

(October term, 1919; April session, 1920)

Henry Fink, collector of internal revenue for the eastern district of Wisconsin, plaintiff in error, v. Northwestern Mutual Life Insurance Co., defendant in error

Appeal from the district court for the eastern district of Wisconsin

[June, 1920]

Before Baker, Evans and Page, circuit judges

Page, circuit judge: This case comes here on a writ of error to reverse the judgment for plaintiff in the district court, entered by Judge Geiger (see 248 Fed., 568, where the facts are fully stated). The insurance company, the defendant in error, will herein be known as plaintiff and the collector of internal revenue, plaintiff in error, will herein be known as defendant.

The commissioner of internal revenue amended plaintiff's returns of income for the years 1909 and 1910, filed under the excise tax law of August 5, 1909, and thereby greatly increased the tax. This suit was brought to recover that increase, paid under protest.

Defendant states the following as the questions involved, and they will be determined as written:

I

1. Whether dividends applied at the option of the policyholders to purchase paid-up additions and annuities were not income for the year in which so applied within the meaning of the act.

2. Whether dividends applied at the option of the policyholders in partial payment of renewal premiums were not income for the year in which so applied within the meaning of the act.

The excise tax act of August 5, 1909 (36 Stats. L., ch. 6, p. 11 (112), provides:

* * * Every insurance company * * * organized under the laws * * * of any state * * * shall be subject to pay annually a special excise tax * * * equivalent to one per centum upon the entire net income over and above $5,000 *received by it from all sources during such year,* exclusive, etc. * * * Such net income shall be ascertained by deducting from the gross amount of the income of such * * * insurance company, *received within the year from all sources,* * * * (second) * * * and in the case of insurance companies the sum other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds;

Disregarding the deductions, the basis for the tax is "income * * * received * * * *during such year.*"

Plaintiff is a mutual insurance company, organized under the laws of Wisconsin, and annually collects level premiums which are sufficiently large to pay the insurance cost, including reserves, and all of the expenses of the business. Usually there is something left over for a surplus, which surplus is required by the laws of the State of Wisconsin to be divided among the policyholders. The dividend of surplus is in no sense a dividend of profits. By dividing such a surplus by means of the so-called "dividend," the company simply says to its policyholders: "There is available to you, from funds heretofore paid by you to this company, a sum of money that may be used by you for the payment of premiums, paid-up additions, annuities, or for whatever use you may choose to make of it."

The excise law did not take effect until January 1, 1909, and, inasmuch as the surplus converted into dividends in 1909 was received by the company before the law went into effect, that surplus, converted into dividends, was not income for 1909. The surplus from premiums, out of which the dividends for 1910 were declared, was a part of the income for 1909, and formed a basis for taxation, under the excise law, for that year, and could not, as dividends, form a basis for further taxation. In other words, the fair interpretation of the statute is that income forms a basis for taxation only for the year in which it was received. *Herold v. Mutual Benefit Life Ins. Co.*, 201 Fed., 918; *Maryland Casualty Co. v. United States,* decided by the Supreme Court of the United States January 12, 1920; *Hays v. Gauley Mt. Coal Co.,* 247 U. S., 192. There is nothing in *Maryland Casualty Co. v. United States,* supra, out of harmony with this interpretation. It was said that funds of an insurance company, which had escaped taxation in the year in which they were received because they had been set aside as a reserve in that year and therefore had formed no basis for taxation, might, if they were released from that reserve to the general uses of the company, be treated as income for the year in which they were so released.

II

3. Whether premiums due and deferred and interest due and accrued, but not actually collected in cash, were not income within the meaning of the act.

In *Hays v. Gauley Mt. Coal Co.,* supra, this question was answered contrary to the contention of the government in the following language:

The expression "income *received during such year,*" employed in the act of 1909, looks to the time of realization rather than to the period of accrue-

ment, except as the taking effect of the act on a specified date (Jan. 1, 1909), excludes income that accrued before that date.

See also *Maryland Casualty Co. v. United States,* supra.

III

4. Whether interest on policy loans, which by the terms of the contract was added to the principal of the loan when it became due and remained unpaid by the policyholders, was not income within the meaning of the act.

This question is answered contrary to the government's contention by *Board of Assessors, etc., v. New York Life Ins. Co.,* 216 U. S., 517.

IV

5. Whether increases in the value of assets because of accrual of discounts were not income, and decreases in value of assets because of amortization of premiums on bonds were a deduction from income under the act.

In the reassessment the commissioner added to income for the two years a total as "accrual of discount" of $67,268.96, and deducted for "depreciation" (amortization of bonds) for the two years $231,654.86. In his findings of fact, Judge Geiger said:

Plaintiff waived objection in each amended return made by the commissioner of internal revenue to the item "accrual of discount" and to the item "depreciation."

Thereupon the court disposed of those items by deducting the "accrual of discount" from the "depreciation," giving plaintiff a net deduction of $164,385.90. Inasmuch as plaintiff waived objection to items "accrual of discount," the propriety of such a charge will not be discussed here. If deduction by reason of amortization of premiums on bonds was proper, it must have been so under the following provision of the statute, viz.:

All losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any.

There was no sale. The item arose from mere book adjustments. In our opinion amortization of bonds does not come within any definition of "depreciation" under this or similar acts. In considering the excise statute, the supreme court has said:

What was here meant by "depreciation of property?" We think congress used the expression in its ordinary and usual sense as understood by business men. It is common knowledge that business concerns usually keep a depreciation account, in which is charged off the annual losses for wear and tear, and obsolescence of structures, machinery, and personality in use in the business.

The court then said that it did not consider the statute covered a depreciation of a mine by exhaustion of the ores. *Von Baumbach v. Sargent Land Co.,* 242 U. S., 534. See also *Lumber Mut. Fire Ins. Co. v. Malley,* 256 Fed., 383; *Baldwin L. Works v. McCoach,* 221 Fed., 59; *Van Dyke v. Milwaukee,* 159 Wis., 460.

Plaintiff's claim that this question is not within the issues in this case is clearly overborne by its second and eleventh assignments of reasons why the tax is excessive and illegally assessed, viz.:

2. No greater amount of taxes should have been * * * collected * * * for the year 1909 than the sum of $43,729.78, etc.

Number 11 is similar. It seems clear that a suit of this character is for all purposes a contest between the government and the taxpayer, the question being, how much tax should the plaintiff have paid? In *Crocker v. Malley,* 249 U. S., 223, the court found that the tax actually assessed against the

plaintiffs as a joint stock association was improperly assessed and collected because the plaintiffs were not a joint stock association, but simply trustees. At page 235 the court said:

The district court, while it found for the plaintiffs, ruled that the defendant was entitled to retain * * * the amount of the tax that they should have paid as trustees. * * * The commissioner of internal revenue rejected the plaintiffs' claim, and the statute does not leave the matter clear. The recovery, therefore, will be from the United States. (Rev. Stats., sec. 989.) The plaintiffs, as they themselves alleged in their claim, were the persons taxed, whether they were called an association or trustees. They were taxed too much. If the United States retains from the amount received by it the amount that it should have received, it cannot recover that sum in a subsequent suit.

See also *Missouri River, F. S. & G. R. Co. v. United States,* 19 Fed., 67. Plaintiff cites the Eaton cases, 218 Fed., 188. The reason given by the court, in the first case, for allowing items "bonds for accrual of discount" and "bonds for amortization of premiums" is—

Because the testimony shows that the method of annually scaling down the book values of bonds purchased at a premium, and making additions to the book value of bonds purchased below par * * * is in accordance with the law and the requirements of the insurance departments of the different states.

The record here shows no such practice by plaintiff. What law that action was in accordance with the decision does not say, but it certainly was not in accordance with the excise tax act. Whether it was in accordance with the requirements of the insurance departments of the different states makes no difference. The only clause, if any, under the excise law which would permit the commissioner to exercise any influence upon deductions is the following, relating to deductions: "The net addition, if any, required by law to be made within the year to reserve funds." Under authority of *Maryland Casualty Co. v. United States,* supra, the requirement of the insurance commissioner as to reserves would be a thing "required by law."

We are of opinion that decreases in value of assets because of amortization of premiums on bonds were not a proper deduction, and that there should be deducted from the judgment of the court below the sum of $1,643.86, with interest thereon at the rate of 6 per cent from January 22, 1912, to the date of the entry of the original judgment on November 16, 1917.

V

6. Whether an addition to the reserve funds because of liability on supplementary contracts not involving life contingencies and canceled policies upon which a cash surrender value may be demanded was deductible from gross income under the act.

The excise law permits insurance companies to deduct "the net addition, if any, required by law to be made within the year to reserve funds."

Section 1952 of the Wisconsin state law provides:

In determining the amount of the surplus to be distributed there shall be reserved an amount not less than the aggregate net value of all the outstanding policies.

Under this section and section 1950, the insurance commissioner of Wisconsin, as of December 31, in the years 1908, 1909 and 1910, certified his computation of reserves, and did not include reserves as against the contracts in question.

All the actuary would say about what was required by the insurance commissioner with reference to the reserve in question was, that the blank

that the company was compelled to fill in contained an item "reserve liabilities," but that no such item was included in "net reserve funds."

Section 1946x defines " 'reserve' at any time within the policy year" and "terminal reserve." The latter is defined to be—

The sum sufficient, with the net premiums coming due, to provide for the future mortality charges, and mature the policy according to its terms, all computed upon the table of mortality adopted and the rate of interest assumed.

The end to be reached in life insurance is to mature the policy by building up a reserve. The basis of arriving at that desired end is the table of mortality and the rate of interest assumed, and by the use of them the net premium is fixed and the reserve is built up from net premiums. Repeating the process of making the terminal reserve from year to year until the time when the payment of premiums ceases, matures the policy. The net premium coming due is the foundation of the reserve. Actuary Evans states it thus:

The reserve is the balance of cash that the company must have on hand in order to pay out the contract, assuming that the future premiums under the policy are paid to the company, or, in other words, the increase in the reserve on the policy would be, specifically, the amount of the premium for that year paid in, interest on the entire sum, and the cost of the insurance deducted.

The assistant secretary (Anderson) explained that—

When the policy becomes a claim, it is charged off in the death loss account as a disbursement * * * for the full amount of the * * * policy.

When asked what, if anything, is deducted from the general reserve fund when death occurs, he answered:

A corresponding amount to the death loss which was taken out of disbursements—the reserve—is held on that policy. I mean that one part of reserve account is wiped out and another created.

Just here is the misconception as to what is a life insurance reserve. The reserve meant in the law is that fund which is built up to mature the policy. Of course, at the time when the money is taken out of the reserve account and is not used for immediate payment, it must be held somehow. In other words, it is reserved for the purpose of future payment. The full amount is there at the beginning, and there is nothing that has to be built up or matured. Nothing more can be reserved on that account.

We are of opinion that the decrease in the net value of assets because of amortization of premiums on bonds was not proper, and that the decrease in the net value of assets because of liability on supplementary contracts not involving life contingencies and canceled policies upon which a cash surrender value may be demanded was not proper, and that there should be deducted from the judgment of the court below on account of the first item the sum of $1,643.86, and on account of the latter item the sum of $9,969.08, an aggregate of $11,612.94, as of January 22, 1912, and that judgment should be entered for the sum of $131,755.84, being the principal of the original judgment less said sum of $11,612.94, with interest thereon at 6 per cent from January 22, 1912, with costs in the district court, which said interest amounts, to the date of the entry of the judgment in the district court on December 16, 1917, to $46,641.57. It is adjudged that each party pay its own costs of the proceedings in this court.

(T. D. 3058, August 16, 1920)

Income tax

Section 203, revenue act of 1918—Inventories of retail dry-goods dealers

Regulations No. 45 are hereby amended by inserting article 1588, reading as follows:

ART. 1588. *Inventories of retail dry-goods dealers.* (1) Retail dry-goods dealers who employ the "retail method," which is essentially a "cost" method of valuing inventories, will be permitted to make their returns upon that basis, provided (*a*) that the use of such method is designated upon the return (*b*) that accurate accounts are kept, and (*c*) that such method be adhered to in subsequent years, unless a change is authorized by the commissioner. The "retail method" consists in computing the "cost" of goods on hand from the "percentage of purchase mark-up" and the "retail value" of goods on hand.

(2) A taxpayer employing the "retail method" of valuing inventories shall maintain and preserve in permanent form, for the inspection of internal revenue officers, the accounts and records of each year, together with a schedule of all mark-downs in each department, and such mark-downs shall not be included in the computation of the retail value of goods on hand unless the goods so marked down have been actually sold.

(3) The following general plan of taking an inventory by the "retail method" will, it is believed, be found readily adaptable to the requirements of most retail dry-goods dealers:

(A) The *percentage of purchase mark-up* is computed as follows: The value of all merchandise, as received, is recorded by departments at two prices—(*a*) invoice cost plus transportation, and (*b*) original retail sale price. These cost and retail values are accumulated as recorded during the year. The total retail value minus the total cost value equals the total purchase mark-up, which divided by the total retail value gives the percentage of purchase mark-up.

(B) The *retail value of goods on hand* is computed as follows: A record is kept of (*a*) the amounts of all sales at retail; (*b*) any variations from the inventory prices of the preceding year of goods carried over from that year, and (*c*) any variations from the original sale prices, such as subsequent mark-ups or mark-downs (note par. 2). The retail value of the opening inventories plus the retail value of the purchases (plus or minus the algebraic sum of all subsequent mark-ups and mark-downs in the case of goods actually sold), minus the retail value of the sales equals the retail value of the book inventory of goods on hand. Physical inventories by departments are taken of goods on hand at retail at the close of the taxable year, and the retail value of the book inventory of goods on hand is adjusted accordingly.

(C) The *cost of goods on hand* is computed by subtracting from 100 per cent the percentage of purchase mark-up, which gives the percentage of cost, and multiplying the retail value of goods on hand by such percentage of cost.

(T. D. 3059, August 16, 1920)

Income tax

Stock dividends—Articles 1545, 1546 and 1642 of regulations No. 45 revoked, and article 1547 amended

In accordance with the recent decision of the supreme court of the United States in the case of *Eisner v. Macomber* (T. D. 3010), holding that a stock dividend is not taxable income to the stockholder, articles 1545, 1546 and 1642 of regulations No. 45 are hereby revoked, and article 1547 is amended to read as follows:

ART. 1547. *Sale of stock received as dividend.* Stock received as a dividend does not constitute taxable income to the stockholder, but any profit derived by the stockholder from the sale of such stock is taxable income to him. For the purpose of ascertaining the gain or loss derived from the sale of such stock, or from the sale of the stock with respect to which it is issued,

the cost (used to include also, where required, the fair market value, as of March 1, 1913), of both the old and new shares is to be determined in accordance with the following rules:

(1) Where the stock issued as a dividend is all of substantially the same character or preference as the stock upon which the stock dividend is paid, the cost of each share of both the old and new stock will be the quotient of the cost, or fair market value as of March 1, 1913, if acquired prior to that date, of the old shares of stock divided by the total number of the old and new shares.

(2) Where the stock issued as a dividend is in whole or in part of a character or preference materially different from the stock upon which the stock dividend is paid, the cost, or fair market value as of March 1, 1913, if acquired prior to that date, of the old shares of stock shall be divided between such old stock and the new stock, or classes of new stock, in proportion, as nearly as may be, to the respective values of each class of stock, old and new, at the time the new shares of stock are issued, and the cost of each share of stock will be the quotient of the cost of the class to which such share belongs divided by the number of shares in that class.

(3) Where the stock with respect to which a stock dividend is issued was purchased at different times and at different prices and the identity of the lots cannot be determined, any sale of the original stock will be charged to the earliest purchases of such stock (see art. 39), and any sale of dividend stock issued with respect to such stock will be presumed to have been made from the stock issued with respect to the earliest purchased stock, to the amount of the dividend chargeable to such stock.

(T. D. 3061, August 27, 1920)

Income tax

Deductions allowed—Depreciation—Article 166, regulations No. 45, amended

Article 166 of regulations No. 45 is hereby amended to read as follows:

ART. 166. *Modification of method of computing depreciation.*—If it develops that the useful life of the property has been underestimated, the plan of computing depreciation should be modified and the balance of the cost of the property, or its fair market value as of March 1, 1913, not already provided for through a depreciation reserve or deducted from book value, should be spread over the estimated remaining life of the property. Inasmuch as under the provisions of the income-tax acts in effect prior to revenue act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was sold or permanently abandoned, a taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art. No modification of the method should be made from the normal progress of the art. No modification of the method should be made on account of changes in the market value of the property from time to time. such as, on the one hand, loss in rental value of the buildings due to deterioration of the neighborhood, or, on the other, appreciation due to increase demand. The conditions affecting such market values should be taken into consideration only so far as they affect the estimated useful life of the property.

(T. D. 3062, September 1, 1920)

Income tax

Income to lessors of improvements made upon real estate by lessees—Articles 48, 109 and 164, regulations No. 45, amended

Articles 48, 109 and 164 of regulations No. 45 are hereby amended to read as follows:

ART. 48. *Rents and royalties.*—When buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor receives income at the time when such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements. If for any other reason than a bona fide purchase from the lessee by the lessor, the lease is terminated, so that the lessor comes into possession and control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the fair market price or value thereof to him as determined when the same completed became part of the realty. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the termination of the lease the lessor is entitled to deduct as a loss of the year when such destruction takes place the fair market price or value of such buildings or improvements subject to the lease as determined when the same completed became a part of the realty, or the value thereof subject to the lease on March 1, 1913, less any salvage value subject to the lease, to the extent that such loss was not compensated by insurance. (See articles 109 and 164.)

ART. 109. *Rentals.*—Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent, and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvement made, this deduction shall take the form of an allowance for depreciation. (See article 48.)

ART. 164. *Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost of the property in respect of which the allowance is made, except that in the case of property acquired by the taxpayer prior to March 1, 1913, the capital sum to be replaced is the fair market value of the property as of that date. In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property less depreciation up to that date. To this sum should be added from time to time the cost of improvements, additions and betterments, the cost of which is not deducted as an expense in the taxpayer's return, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility, which is the basis of the depreciation allowance. In the case of the acquisition after March 1, 1913, of a combination of depreciable and non-depreciable property for a lump price, as, for example, land and buildings, the capital sum to be replaced is limited to that part of the lump price which represents

the value of the depreciable property at the time of such acquisition. Where the lessee of real property erects buildings, or makes permanent improvements which become part of the realty and income or loss has been returned by the lessor as a result thereof, as provided in article 48, the capital sum to be replaced by depreciation allowances is held to be the same as though no such building had been erected or such improvements made.

(T. D. 3064, September 4, 1920)

Income tax

Deductions allowed—Depletion—Article 211, regulations No. 45, amended

Article 211, regulations No. 45, is hereby amended to read as follows:

ART. 211. *Computation of allowance for depletion of gas wells.*—On account of the peculiar conditions surrounding the production of natural gas it will be necessary to compute the depletion allowance for gas properties by methods suitable to the particular cases in question and acceptable to the commissioner. Usually the depletion of natural gas properties should be computed on the basis of decline in closed or rock pressure, taking into account the effects of water encroachment and any other modifying factors. The gas producer will be expected to compute the depletion as accurately as possible and submit with his return a description of the method by which the computation was made. The following formula, in which the units of gas are pounds per square inch of closed pressure, is recommended: The quotient of the capital account recoverable through depletion allowances to the end of the taxable year divided by the sum of the pressures at the beginning of the year, plus the sum of initial pressures of new wells and less the sum of the pressures at the time of expected abandonment (which quotient is the unit cost), multiplied by the sum of the pressures at the beginning of the taxable year, plus the sum of the initial pressures of new wells and less the sum of the pressures at the end of the tax year equals the depletion allowance.

Smith, Brodie & Lunsford announce the opening of offices at 2107-2109 Woolworth building, New York.

McLaren, Goode & Co., San Francisco, announce that Norman Loyall McLaren has been admitted to partnership.

Spragg, Lotz & Smith announce the opening of an office in the Central Savings Bank building, Canton, Ohio.

Edward R. Burt & Co. announce the opening of an office at 603 Union Trust building, Cincinnati, Ohio.

Walter M. Finlay announces the opening of an office in the Finlay building, Greenville, South Carolina.

Lingley, Baird & Dixon announce the opening of an office at Eldon Street House, Eldon street, London, E. C., England, under the direction of Baker, Sutton & Co.